NO. 26

IN THE

Supreme Court of the United States

OCTOBER TERM, 1939

F. H. E. OIL COMPANY, *Petitioner*,

vs.

COMMISSIONER OF INTERNAL REVENUE.

On Writ of Certiorari to the United States Circuit Court of Appeals for The Fifth Circuit

BRIEF FOR THE PETITIONER

HARRY C. WEEKS,
910-13 Sinclair Building,
Fort Worth, Texas.
Counsel for Petitioner.

Commercial Recorder—Fort Worth, Texas—2-5398.

INDEX

	Pages
Opinion below	1
Jurisdiction	1
Question presented	2
Statutes involved	3
Statement	4
Specification of error to be urged	9
Summary of Argument	9
Argument	15-76
I. Authoritative construction of correlative phrase "gross income from the property" requires that "net income * * * from the property" be determined by deducting only operating expenses from such gross income	15
II. Intangible drilling and development costs are not an operating expense, even though their deduction in calculating net taxable income from all sources is required	28
III. The history of this depletion limitation phrase requires this construction and renders the change in Regulations attempted in 1929, upon which Respondent relies, a nullity	37
IV. Discussion of the conflicting decisions by the Fifth and Ninth Circuits and other rulings dealing with the question	62
V. Equitable reasons support Petitioner's position	76
Conclusion	80-81
Appendix	83-102

INDEX—Continued

Excerpts from: Pages
Revenue Act of 1932 83
Revenue Act of 1921 86
Revenue Act of 1924 87
Revenue Act of 1926 88

Excerpts from:
Regulations 62 (1921 Act) 88
Regulations 65 (1924 Act) 90
Regulations 69 (1926 Act) 91
Regulations 74 (1928 Act) 92
Regulations 77 (1932 Act) 93

G. C. M. 2315 96

G. C. M. 5104 98

Excerpt from Gregg "Statement" 100

Excerpts from:
Senate Finance Committee Report (1924 Act) 100
Senate Finance Committee Report (1926 Act) 101
House Conference Report (1926 Act) 102

AUTHORITIES

Cases:

Ambassador Petroleum Company v. Commissioner, 28 B. T. A. 868; 81 Fed. (2d) 474 ..... 9, 45, 49, 53, 62, 64, 70

Blankenship v. United States, 95 Fed. (2d) 507 18
Brewster v. Gage, 280 U. S. 327 53

Commissioner v. Wilshire Oil Company, Inc., 95 Fed. (2d) 971 ..... 9, 49, 53, 64, 75, 80
Consumers Natural Gas Company, 30 B. T. A. 1263; 78 Fed. (2d) 161 19
Crews, Ralph W. v. Commissioner, 37 B. T. A. 387 48
Crossett Timber & Development Company v. Commissioner, 29 B. T. A. 705 18

Darby-Lynde Company v. Alexander, 51 Fed. (2d) 56 ..... 17, 19

AUTHORITIES—Continued

	Pages
Fleming v. Commissioner, 82 Fed. (2d) 324	18, 20
Greensboro Gas Company, 30 B. T. A. 1362; 79 Fed. (2d) 701	19
Hartley v. Commissioner, 295 U. S. 216	54
Helvering v. Bankline Oil Company, 303 U. S. 362	16, 18, 21
Helvering v. Elbe Oil Land Development Company, 303 U. S. 372	17, 18, 21
Helvering v. Mountain Producers Corporation, 303 U. S. 376	17, 18, 22, 23
Helvering v. New York Trust Company, 292 U. S. 455	43, 45, 64, 68
Helvering v. O'Donnell, 303 U. S. 370	16, 18, 21
Helvering v. Reynolds Tobacco Company, 306 U. S. 110	57
Helvering v. Twin Bell Oil Syndicate, 293 U. S. 312	16, 19, 20
Herring v. Commissioner, 293 U. S. 323	16, 19
Hunt Production Company v. Commissioner, 38 B. T. A. 457	48
Los Angeles, etc. Corporation v. Railroad Commission, 58 Fed. (2d) 256	73
Manhattan General Equipment Company v. Commissioner, 297 U. S. 129	55, 57
Massachusetts Mutual Life Insurance Company v. United States, 288 U. S. 269	25
Mayes v. Paul Jones Company, 270 Fed. 121	60, 61
Mountain Producers Corporation v. Commissioner, 34 B. T. A. 409	48
Old Mission Portland Cement Company v. Helvering, 293 U. S. 289	54
Ortiz Oil Company v. Commissioner, 37 B. T. A. 656; 102 Fed. (2d) 508	19, 22, 48
Rawco Incorporated, Ltd. v. Commissioner, 37 B. T. A. 128	18

AUTHORITIES—Continued

	Pages
Rocky Mountain Oil Company v. Commissioner, 36 B. T. A. 365	48
Rudman, I. v. Commissioner, 36 B. T. A. 803	48
Sneed, J. T. Jr. v. Commissioner, 33 B. T. A. 478	18
Squibb, E. R. & Sons v. Helvering, 98 Fed. (2d) 69	57
Thomas v. Perkins, 301 U. S. 655	20, 22
United States v. Dakota-Montana Oil Company, 288 U. S. 459	41, 65, 70
United States v. Spalding, 97 Fed. (2d) 701	18
Walker v. United States, 83 Fed. (2d) 103	52
Wilshire Oil Company, Inc. v. Commissioner, 35 B. T. A. 450	48
Statutes:	
Revenue Act of 1918:	
Sec. 214(a)(10)	15, 37
Sec. 234(a)(9)	15, 37
Revenue Act of 1921:	
Sec. 214(a)(10)	15, 38
Sec. 234(a)(9)	15, 29, 38, 86, 87
Revenue Act of 1924:	
Sec. 204(c)	40, 87, 88
Sec. 214(a)(10)	15
Sec. 234(a)(9)	15
Revenue Act of 1926:	
Sec. 204(c)(2)	15, 41, 88
Sec. 214(a)(10)	15
Sec. 234(a)(9)	15
Revenue Act of 1928:	
Sec. 23(l)	46
Sec. 114(b)(3)	15, 46

AUTHORITIES—Continued

Pages

Revenue Act of 1932:
- Sec. 11 17
- Sec. 12 17
- Sec. 13 17
- Sec. 21 ..... 17, 83
- Sec. 22 ..... 17, 83
- Sec. 23 ..... 3, 17, 83, 84, 85, 86
- Sec. 114(b)(3) 3, 5, 9, 15

Revenue Act of 1934:
- Sec. 114(b)(3) 15

Revenue Act of 1936:
- Sec. 114(b)(3) 15

Revenue Act of 1938:
- Sec. 114(b)(3) 15

Treasury Regulations and Decisions:
- G. C. M. 2315, C. B. VI-2, p. 21 ..... 39, 41, 42, 62, 96, 97, 98
- G. C. M. 5104, C. B. VII-2, p. 115 ..... 71, 98, 100

Regulations 45 (1918 Act):
- Article 223 5

Regulations 62 (1921 Act):
- Article 201(h) 30, 33, 38, 88, 89, 90
- Article 223 30

Regulations 65 (1924 Act):
- Article 201(h) 33, 90, 91

Regulations 69 (1926 Act):
- Article 201(h) 33
- Article 221 ..... 91, 92

Regulations 74 (1928 Act):
- Article 221(i) 34, 47, 92

Regulations 77 (1932 Act):
- Article 221(g) 24, 93, 94, 95, 96, 97
- Article 221(h) 34
- Article 236 ..... 4, 5

AUTHORITIES—Continued

	Pages
T. D. 4025, C. B. VI-1, p. 75	67
T. D. 4333, C. B. XI-1, p. 31	5

Other Authorities:

Excerpt from Treasury Statement of Change (1924 Act) 39, 100, 101

House Committee Report No. 356, p. 32 (69th Congress—1st Session) 41, 101, 102

Ruling Case Law, Vol. 25, p. 983 71

Senate Finance Committee No. 52, p. 17 (69th Congress—1st Session) 41, 101

Senate Finance Committee No. 398, p. 20 (69th Congress—1st Session) 40, 101

NO. 26

IN THE

Supreme Court of the United States

OCTOBER TERM, 1939

F. H. E. OIL COMPANY, *Petitioner*,

vs.

COMMISSIONER OF INTERNAL REVENUE.

On Writ of Certiorari to the United States Circuit Court of Appeals for The Fifth Circuit

BRIEF FOR THE PETITIONER

OPINIONS BELOW

The opinion of the Circuit Court of Appeals (R. 45) is reported at 102 Fed. (2d) 596. The opinion of the Board of Tax Appeals (R. 26) was not published.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered March 21, 1939 (R. 49). Petition for Writ of Certiorari was filed on April 4, 1939, and granted

on May 1, 1939 (R. 51). The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

The Revenue Act of 1932 provided that the depletion allowance in the case of oil and gas wells, when not computed upon the basis of cost or value as of March 1, 1913, should be "27½ per centum of the gross income from the property," but not more than "50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property."

The Petitioner contends that in applying the limitation contained in this formula only the current expenses of *operating* the property are to be deducted from the "gross income from the property" to arrive at the "net income of the taxpayer * * * from the property."

The Respondent's position is that certain costs incurred by the Petitioner in the tax year *in developing*, as distinguished from *operating*, the property should also be deducted in computing the limitation because that much of such development costs had been deducted by Petitioner in computing its taxable net income from all sources, as it was required to do because of a prior irrevocable election to deduct such development costs currently, rather than to capitalize them.

STATUTES INVOLVED

Revenue Act of 1932:

"Sec. 23. *Deductions From Gross Income.*

In computing net income there shall be allowed as deductions: * * *,

(1) *Depletion.* In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowances in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. * * *

(For percentage depletion, see Section 114 (b) (3) and (4)).

Section 114. *Basis for Depreciation and Depletion.* * * *

(b) *Basis for Depletion.* * * *

(3) *Percentage Depletion For Oil and Gas Wells.* In the case of oil and gas wells the allowance for depletion shall be 27½ per centum of the gross income from the property during the taxable year, excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance be less than it would be if computed without reference to this paragraph."

Other statutory provisions less directly involved will be found in the Appendix (Pages 83 to 88, infra).

STATEMENT

Petitioner, an oil producing company, was chartered in 1925 (R. 47). During its tax year here involved, the fiscal year ended January 31, 1932, it owned interests in twenty producing properties and sold therefrom some $80,000 worth of oil, which was reported as its gross income from these properties (R. 18-A).

On thirteen of those properties Petitioner had carried on development work in that fiscal year (R. 18-A). In computing its taxable income for the period, it deducted the "intangible drilling and development costs"[1] incurred in this development work

---

[1]Intangible drilling and development costs, as the term is used here, are defined in *Art. 236, Treasury Regulations 77*, in the following language:

> "All expenditures for wages, fuel, repairs, hauling, supplies, etc., incident to and necessary for the drilling of wells and the preparation of wells for the production of oil or gas * * *. Such expenditures have for convenience been termed intangible drilling and development costs. Examples * * * are, all amounts paid for labor, fuel, repairs, hauling and supplies, or any of them, which are used (A) in the drilling, shooting and cleaning of wells; (B) in such clearing of ground, draining, road making, surveying, and geological work as are necessary in preparation for the drilling of wells; and (C) in the construction of such derricks, tanks, pipe lines, and other physical structures as are necessary for

(R. 39), amounting to $25,177.43 (R. 18-A). The correctness of this practice is not in question here. It was done in accordance with an option granted oil producers either to capitalize such intangible drilling and development costs and treat them as additional costs of the oil reserves, or to charge them off currently in computing the taxable income (R. 39. Reg. 77, Art. 236).

This option was first granted oil producers under the Revenue Act of 1918, and it has been continued under all later Acts. Each taxpayer was required to follow in all subsequent years the method originally selected,[2] and Petitioner did this. Petitioner made its election in 1925 (R. 39).[3]

In computing Petitioner's allowances for percentage[4] depletion the Respondent took as Petitioner's

---

the drilling of wells and the preparation of wells for the production of oil or gas."

In general, the term "applies only to expenditures for those drilling and development items which in themselves do not have a salvage value." The term will be used in that sense throughout this brief.

[2]Reg. 45 (1918 Act) Art. 223, and corresponding articles of later Regulations, restated in T. D. 4333, C. B. XI-1, p. 31; Reg. 77 (1932 Act), Art. 236.

[3]In 1927, the right to change the practice was granted under certain conditions, if exercised in six months. See footnote 81, p. 67, infra.

[4]The term "percentage depletion" will be used to refer to the allowance for depletion of oil properties based upon a percentage of the gross income from the property as provided in Section 114(b)(3) of the Revenue Act of 1932, and corresponding provisions of other Acts.

gross income from each property the amount of oil sold therefrom. He deducted therefrom the production expenses, current depreciation on physical equipment used in production, taxes and a portion of the Petitioner's general overhead expense.[5] No issue is presented as to so much of the calculation. But as to the properties upon which development work had been done in the current year, Respondent also deducted the intangible drilling and development costs and treated the remainder as the "net income of the taxpayer (computed without allowance for depletion) from the property." This reduced the depletion allowable as to ten of the thirteen properties, upon which development work had been done, below the amount which would have been allowed had these intangible drilling and development costs not been deducted in calculating the limitation (R. 18-A).

The difference in the two methods of calculation may be illustrated by the following example, taken from the schedule attached to the Respondent's de-

---

[5]The Respondent allocated 40 per centum of all Petitioner's overhead expense to "lease operations" and distributed the 40 percent so allocated between the several leases upon the basis of oil produced therefrom (R. 18-A).

termination of the deficiency here involved (R. 18-A):

Flemister Lease—

Gross income from the property (styled "oil income" in Respondent's schedule)		$17,186.06
27½ percent of this "gross income from the property"		4,726.17
Deductions in computing "net income * * * from the property":		
	Per Petitioner	Per Respondent
Production expense	$ 797.69	$ 797.69
Depreciation on equipment used in production	499.17	499.17
Taxes	406.22	406.22
Portion of general overhead expense allocated to lease operations	3,599.26	3,599.26
Intangible drilling and development costs ("Development expenses" in Respondent's schedule)	None	4,501.43
Total deductions	$5,302.34	$9,803.77
"Net income * * * from the property"	11,883.72	7,382.29
50% of "net income, etc."	5,941.86	3,691.15
Allowable depletion	4,726.17	3,691.15
	3,691.15	
Difference in the two methods	$1,035.02	

The same calculations as to all of the properties affected show the following differences in allowable depletion:

Lease	Oil Income	Development Costs	Net Income from Property per Petitioner	Net Income from Property per Respondent	Depletion Allowable Per Petitioner	Depletion Allowable Per Respondent
J. E. Christian	$ 2,085.52	$ 1,447.35	$ 1,481.65	$ 34.30	373.52	(1) 26.95
M. Christian	2,769.96	1,025.56	2,038.83	1,013.27	761.74	506.03
R. Christian	3,348.79	2,297.27	2,466.61	169.34	920.92	84.67
B. C. Christian	13,430.80	6,521.23	9,008.65	2,487.42	3,693.47	1,243.71
Clements	4,401.82	1,302.97	3,034.94	1,731.97	1,210.50	865.98
Flemister	17,186.06	4,501.43	11,883.72	7,382.29	4,726.17	3,691.15
W. E. Jones	5,874.18	2,147.30	4,217.18	2,069.88	1,615.40	1,034.94
Thompson A	5,528.93	3,478.43	1,994.86	(1,483.57)	(2) 997.36	(1) 165.36
Thompson B	2,245.80	1,010.60	1,047.52	36.92	528.76	(1) 200.09
Thompson C	2,066.14	719.72	1,085.84	366.12	537.87	183.06
	$58,938.00	$24,452.26			$15,565.71	$8,001.94
					8,001.94	
					$ 7,563.77	

(1)—The depletion actually allowed by the Respondent was based upon cost because, as calculated by him, it exceeded 50% of the "net income * * * from the property."

(2)—Loss.

The Board of Tax Appeals sustained Petitioner's views, relying primarily upon *Ambassador Petroleum Company v. Commissioner*, 81 Fed. (2d) 474 (9th C. C. A.), which it had followed in other cases (R. 26-31). The Circuit Court refused to follow the holding in the *Ambassador Petroleum Company case*, and the later decision of the same Circuit in *Commissioner v. Wilshire Oil Company, Inc.*, 95 Fed. (2d) 971, and reversed the Board (R. 45-49).

SPECIFICATION OF ERRORS TO BE URGED

The Circuit Court of Appeals erred in holding that the intangible drilling and development costs, currently incurred by Petitioner with respect to its several oil properties, should be deducted from its gross income from the respective properties in determining the amount of Petitioner's net income from each of these several properties (calculated before allowance for depletion), by which the depletion allowable to Petitioner upon the percentage of gross income basis provided in *Section 114 (b) (3)* of the Revenue Act of 1932 was limited.

SUMMARY OF ARGUMENT

I.

The phrases "gross income from the property" and "net income of the taxpayer (computed without allowance for depletion) from the property" used in *Section 114 (b) (3)* of the applicable Revenue Act are correlative and the authoritative con-

struction of one of the phrases is controlling in the construction of the other.

The same language has been used in all Revenue Acts beginning with the Revenue Act of 1926. The meaning of "net income of the taxpayer * * * from the property," as used in these Acts, has never been considered by this Court. But on six occasions this Court has considered and construed the phrase "gross income from the property" and the phrase has also been considered and construed on numerous occasions by other Courts and by the Board of Tax Appeals.

These cases hold that "gross income" as used in this depletion formula does not include all of the items of gross income related to the property which come within the definition of gross income contained in the basic Taxing Sections of the law, but is limited to the actual operating receipts,—the proceeds from oil and gas produced.

Among the items which, under decisions by this and lower courts, are to be included in gross taxable income but not in "gross income from the property" are: proceeds from the sale of an oil property with or without the retention of an oil payment interest; that portion of the consideration for oil produced which consisted of development work done on the property by the purchaser of the oil; rentals paid to delay development; damages for failure to develop; and many other receipts closely connected with the property. In the case at bar the gain which the Petitioner derived from developing some of the

properties involved for the account of a co-owner was not included as a part of its "gross income from the property" (R. 41).

All such items of gross taxable income are closely connected with the oil producing property, but are excluded from "gross income from the property" because they are not a part of the gross income derived from operating the property for oil and gas.

Since this phrase has been given such a limited meaning and application, the correlative phrase "net income of the taxpayer * * * from the property" must be given a correspondingly limited construction. Accordingly, it is not synonymous with net income as defined in the basic Taxing Sections, which net income is calculated by subtracting all allowable deductions from the gross income there defined. But it means the profit derived from operating the property, which is to be determined by deducting from the receipts which come within this limited meaning of "gross income from the property" only those items which are true operating expenses.

II.

No part of the cost of drilling and equipping oil wells constitutes an operating expense. This is shown by Respondent's method of computing the "net income of the taxpayer * * * from the property" in those cases in which a taxpayer is not required to deduct intangible drilling and development costs in computing its taxable income; by his classification

of such costs, when deducted in computing taxable income, as a "development" rather than an "operating" expense; by the meaning of the term "operating expenses" in general parlance; and by his treatment of other items closely related to the property which are deducted in computing taxable income but are not used in calculating the depletion limitation.

III.

The limiting language here involved was first used in the Revenue Act of 1921, which provided that the allowance for depletion when based upon discovery value, should not exceed the "net income (computed without allowance for depletion) from the property." Treasury Regulations, promulgated with respect to this provision, provided that only "operating expenses including depreciation and taxes, but excluding any allowance for depletion," were to be deducted from "the gross income from the sale of all mineral products and any other income incidental to the operation of the property for the production of the mineral products," in calculating this limitation. The consistent practice under this Act was not to include intangible drilling and development costs, though deducted in computing taxable income, in the computation. This construction and practice were reported to and expressly approved by Congress, when the Revenue Acts of 1924 and 1926 were passed, using the same language but changing the limitation to 50 per centum of the "net income, etc., from the property."

Congress, by express declaration, intended to

retain the depletion limitation provision of the 1924 Act, when, in the 1926 Act, percentage depletion was substituted for discovery depletion and the same limiting language was continued.

So, when the 1926 Act was passed, this method of computing the limitation became as much a part of the law as if incorporated therein in express language. The subsequent reenactments (1928, 1932, 1934, 1936, 1938) continued this language, Congress gave no further consideration to the question and the Treasury never called attention to any dissatisfaction with the method or to any change in Regulations. The 1936 and 1938 Acts were adopted after the Ninth Circuit Court had approved the original method of construction as applicable to the 1926 Act (the first Act providing for percentage depletion) and the 1938 Act was passed after the same Court had approved that interpretation as applicable to the 1928 Act.

Under these circumstances, the change in Regulations attempted in Regulations 74 (1928 Act), adopted February 15, 1929, which first directed that intangible costs, if deducted in computing taxable income, be considered in calculating the depletion limitation was a nullity, because it was an attempt to adopt a Regulation contrary to express congressional enactment. The attempted change was not approved either by the passage of the Revenue Act of 1932 or any later Act.

The Treasury must continue to use this method until Congress authorizes a change, for the con-

struction is "imbedded in the statute so deep that only legislation" can "dislodge it."

IV.

The holding below was based upon a misconception of the entire problem, the legislative history and pertinent practices of the Bureau of Internal Revenue.

The Board's opinion in the Ambassador case (reversed by the Ninth Circuit) was predicated upon the erroneous premise that Congress, in adopting percentage depletion, did not intend to continue the limitation provision as applied under the 1924 Act.

G. C. M. 2315, is not authoritative and did not require a change in Bureau procedure, it is an ipse dixit opposed to the expressed intention of Congress and was actually modified shortly after its publication.

The majority opinions of the Ninth Circuit in the Ambassador and Wilshire cases correctly weigh legislative history and departmental practices. The Ambassador case is particularly important as the only judicial construction of the depletion limitation provision of the 1926 Act, and one in which the Respondent sought no further review.

V.

Substantial equities support Petitioner's views. In essence, the Respondent seeks to enforce a bargain but to withhold a portion of the consideration. We do not seek a double deduction and one does not

result. We ask only that the formula for computing the depletion limitation be applied as the Respondent first construed it, as Congress approved it and as the Respondent bargained with us it would be construed.

ARGUMENT

I.

In the Revenue Act of 1926,[6] Congress substituted for the provisions which had been contained in the Revenue Acts of 1918, 1921 and 1924,[7] providing for an allowance for depletion with respect to oil and gas properties based upon the value of such properties at the date of discovery, a provision for an allowance for depletion with respect to oil and gas properties based upon a percentage of the taxpayer's gross income from such property. This allowance has been continued in all subsequent Acts[8] without any change in language, except that in the Revenue Act of 1932, with which we are here concerned, the phrase in the first sentence of *Section 114 (b) (3)* "excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of such property" was added as "clarifying in purpose and declaratory of the existing law as administered." *Helvering v.*

---

[6]Sec. 204(c)(2).

[7]Secs. 214(a)(10) and 234(a)(9) Revenue Act of 1918, and corresponding sections of the 1921 and 1924 Acts.

[8]Sec. 114(b)(3) Rev. Acts of 1928, 1932, 1934, 1936 and 1938.

Twin Bell Oil Syndicate, 293 U. S. 312, 322. Thus for thirteen years percentage depletion allowances with respect to oil and gas properties have been computed by a statutory formula which provided that the allowance should be 27½ per centum of the gross income from the property, but not more than 50 percent of the net income of the taxpayer from the property computed before any allowance for depletion.[9]

It cannot be contended that the phrases "gross income from the property" and "net income of the taxpayer * * * from the property" are not so closely related that the authoritative construction of one of the phrases does not require that the other phrase be similarly construed. The phrase "net income of the taxpayer from the property" has never been construed by this Court. But the phrase "gross income from the property" has been before this Court for construction and application on six occasions,[10] and has been considered more often by the lower Courts and the Board of Tax Appeals.

These decisions, hereafter discussed, define that phrase to mean gross receipts from oil and gas produced—gross operating revenue.

When the Revenue Act of 1926 was adopted, the

---

[9]If this allowance is less than that based upon cost or value as of March 1, 1913, a taxpayer may, from year to year, use the higher allowance.

[10]Helvering v. Twin Bell Oil Syndicate, 293 U. S. 312; Herring v. Commissioner, 293 U. S. 323; Helvering v. Bankline Oil Company, 303 U. S. 362; Helvering v. O'Donnell,

question immediately arose whether "gross income from the property" meant all of those items related to the property which are included in the definition of gross income contained in the basic taxing sections of the law,[11] which defined "gross income" to include gains from "sales or dealings" in any kind of property or "gains or profits and income derived from any source whatever." If "gross income from the property" in the percentage depletion section included all items coming within this general definition of gross income (Sec. 22) which were related to the property, it is clear that the allowance for percentage depletion would then be based upon the profit arising from sales of the property, or interests therein, and many other items of gross income related to the property, in addition to actual receipts from oil and gas produced.

Such contentions have been advanced under many fact situations, including (a) the outright sale of a producing property or of an interest therein,[12] (b)

303 U. S. 370; Helvering v. Elbe Oil Land Development Company, 303 U. S. 372; Helvering v. Mountain Producers Corporation, 303 U. S. 376.

[11]By "basic taxing sections" we mean those sections of the Revenue Act of 1926 (i. e., sections 210, 211, 230, 232 and 233) corresponding to the following sections of the Revenue Act of 1932, viz: Secs. 11, 12 and 13, which lay a tax upon the net incomes of individuals and corporations, and Sec. 21, defining the net income so taxed to be gross income, as defined in Sec. 22, less the deductions authorized by Sec. 23. These last sections, in skeleton form, are set out in the Appendix, p. 83, infra.

[12]Darby-Lynde Co. v. Alexander, (10th C. C. A.) 51 F. (2d) 56.

transactions in which cash was received for an interest in an oil and gas property, and the transferor was to receive (or retain) a share of the oil produced or a sum of money equal to the market value of a share of the oil produced, until he had received a specified amount,[13] (c) cases in which a producing property, or stock in the corporation owning the producing property was transferred upon terms providing that the transferor was to receive a share of the profits from the property,[14] (d) a case in which as a part of the consideration for the oil, the purchaser of oil to be produced from a property was to develop and operate the property at its own cost, as well as pay a specified sum for oil purchased.[15] The phrase has been considered in connection with claims for depletion based upon: damages received for failure to develop,[16] delay rentals paid under the ordinary oil and gas lease,[17] the receipts from casinghead gas plants,[18] the proceeds from the sale of participating certificates of interests in a producing property,[19] the amount received as a bonus or ad-

[13]Fleming v. Commissioner, (5th C. C. A.) 82 F. (2d) 324, and many others.

[14]Helvering v. Elbe Oil Land Development Co., 303 U. S. 372; Helvering v. O'Donnell, 303 U. S. 370; United States v. Spalding, (10th C. C. A.) 97 F. (2d) 701; Blankenship v. United States, (5th C. C. A.) 95 F. (2d) 507.

[15]Helvering v. Mountain Producers Corporation, 303 U. S. 376.

[16]Crossett Timber & Development Co., 29 B. T. A. 705.

[17]J. T. Sneed, Jr., 3 B. T. A. 478.

[18]Helvering v. Bankline Oil Company, 303 U. S. 362.

[19]Rawco Incorporated, Ltd., 37 B. T. A. 128.

vance royalty upon the execution of an oil and gas lease,[20] the amount received as the consideration for the creation of an oil payment, which was held to be a transfer of oil in place, and under other circumstances.[21]

In all of these cases it was held that the phrase "gross income from the property" meant the taxpayer's gross receipts from operations, from the actual oil and gas in which he had the substantial rights of an owner, but did not include other items closely related to the property which were clearly a part of his gross income, as defined in Section 22.

Perhaps the first case was *Darby-Lynde Company* (10th C. C. A.), 51 Fed. (2d) 56, certiorari denied, involving the sale of oil producing properties by the Darby-Lynde Company to the Darby-Lynde Petroleum Company. Depletion was claimed upon the sale price. The Court said:

> "In order to reach a reasonable and rational result, the words 'gross income' as used in Section 204 (c) (2) must be construed as meaning the gross income produced *from the operation of such oil and gas wells.*[22] The language is clearly susceptible of the construction that it

---

[20]Herring v. Commissioner, 293 U. S. 322.

[21]Ortiz Oil Company v. Commissioner, 102 Fed. (2d) 508; Helvering v. Twin Bell Oil Syndicate, 293 U. S. 312; Greensboro Gas Company, 79 Fed. (2d) 701, 30 B. T. A. 1362; Consumers Natural Gas Company, 78 Fed. (2d) 161, 30 B. T. A. 1263.

[22]Italics throughout are ours unless otherwise noted.

is income from or out of the property itself; not out of its sale."

Fleming v. Commissioner (5th C. C. A.) 82 Fed. (2d) 324,[23] involved the extent to which depletion should be allowed upon the down payment and the proceeds thereafter derived from oil payments where Fleming had assigned producing oil properties for cash, and a fixed amount to come from one-fourth of subsequent production. The Court held that percentage depletion could be based upon oil payment receipts because they came, in effect, from oil excepted or reserved in the conveyance, but that the "cash down" payment was not a part of the "gross income from the property." This decision has been followed in numerous cases and was cited in *Thomas v. Perkins*, 301 U. S. 655.

This Court considered the phrase in *Helvering v. Twin Bell Oil Syndicate*, 293 U. S. 312, and used language which we believe is controlling here. The Court said (P. 320):

> "The words used are, 'the allowance for depletion shall be 27½ per centum of the *gross income from the property* during the taxable year.'[24] Is the italicized phrase synonymous with the taxpayer's gross income as defined in Section 213? It cannot be if 'property' signifies the tract of land in all its uses, others as

---

[23]The same question was involved in several other cases decided by that court on the same day.

[24]Italics by the Court.

> well as the extraction of oil and gas. Darby-Lynde Co. v. Alexander, 51 Fed. (2d) 56. The phrase, we think, points only to the gross income from oil and gas. Compare: United States v. Dakota-Montana Oil Co., 288 U. S. 459, 461; Greensboro Gas Co. v. Commissioner, 30 B. T. A. 1361."

Thus this Court expressly refused to expand the phrase or construe it as syonymous with gross income as defined in the basic taxing sections.

Helvering v. Bankline Oil Company, 303 U. S. 362, involved the operator of a casinghead gasoline plant, which had contracts to take and process on a royalty basis the wet gas from oil wells. In holding that it was not entitled to any allowance for depletion upon its income from such operations, this Court said:

> "The percentage is 'of the gross income from the property,'—a phrase which 'points only to the gross income from oil and gas.' Helvering v. Twin-Bell Oil Syndicate, 293 U. S. 312, 321."

The depletion deduction was denied, not because the income of Bankline Oil Company was not closely connected with or directly related to an oil and gas property (for obviously it was), but because it "was not engaged in production." In decisions rendered the same day, *Helvering v. O'Donnell*, 303 U. S. 370, and *Helvering v. Elbe Oil Land Development Company*, 303 U. S. 372, this Court applied the same reasoning. In the *Elbe Oil Land Company case* it was stated:

"The words 'gross income from the property' as used in the Statute governing the allowance for depletion, means gross income *received from the operation of the oil and gas wells* by one who has a capital investment therein,—not income from the sale of the oil and gas properties themselves."

In *Thomas v. Perkins*, 301 U. S. 655, this Court said of its opinion in the Twin-Bell Syndicate cases:

"Our opinion shows that the phrase 'income from the property' means income from oil and gas only, etc."

In *Ortiz Oil Company v. Commissioner* (5th C. C. A.), 102 Fed. (2d) 508, an oil producing company had agreed, in order to obtain funds with which to acquire and develop additional properties, that it would "pay and account" to those who advanced the funds for fractions of the oil to be produced from all of its properties until they had received more than twice the amount advanced. Although holding that this sum "was the cash consideration for a conveyance of stipulated portions of oil production to the extent in value of $359,333.34 if, as and when the oil was produced," the Court held that the Ortiz Oil Company was not entitled to percentage depletion thereon, as "such *income* is not subject to reduction by the percentage depletion allowance which applies only to *income arising from the operation of oil and gas wells.*"

In *Helvering v. Mountain Producers Corporation*, 303 U. S. 376, the Wyoming Associated had a con-

tract with Midwest Refining Company to sell it all of the oil produced from certain properties upon a sliding scale of prices based upon the average price received by the Refining Company for gasoline and kerosene. In addition to cash to be paid, "the Refining Company agreed, *as a part of the price of the oil thus purchased*, to drill, case and maintain all wells, supply water, install and operate pumps and conduct all development and production operations." It was contended:

> "* * * That the gross income of Wyoming Associated from its properties during the taxable year, for the purpose of the statutory allowance for depletion, consisted of the total cash payments received by Wyoming Associated, plus the cost of production defrayed by the Refining Company under its contract."

The Court said:

> "*The government argues that the cash price received for the oil is the seller's entire 'gross income from the property'* where, as in this instance, the oil is purchased under a contract by which a refiner agrees to defray the expense of the development and production operations and to pay a cash price, etc. * * * We think that the government's argument is sound. The evident purpose of the statutory provision controls. It is a unique provision to meet a special case. * * * The rule being of this sort for obvious purposes of administrative convenience, we must apply it in the simple manner it contemplates. The 27½ percent allowed is a fixed factor, not to be

> increased or lessened by asserted equities. The term 'gross income from the property' means gross income from the oil and gas (Helvering v. Twin Bell Syndicate) supra and the term should be taken in its natural sense. * * * We are of the opinion that the cash payments made by the Refining Company constituted the gross income of Wyoming Associated and was the basis for the computation of the depletion allowance."

These cases, and those heretofore cited,[25] show conclusively that this Court and all others who have dealt with the section have consistently held that "gross income from the property" is not synonymous with "gross income" as defined in the basic taxing sections, but is limited to the actual receipts by the taxpayer from oil and gas. In the Regulations adopted under the Act with which we are here concerned the phrase is said to mean the amount for which a taxpayer sells the oil and gas.[26]

This Petitioner derived a substantial amount of income in the following way (R. 39-43): It and another corporation jointly owned many of the properties involved. The Petitioner contracted with its co-owner to drill and equip wells upon these properties at a fixed price per foot, and earned a substantial profit from so developing these properties. This profit was reported as a part of its gross income under Section 22, but, though this profit was as

---

[25]Footnotes 12 to 21, pp. 17 to 19, supra.

[26]Art. 221(g), Reg. 77.

closely connected with the property as were its own development costs, this sum was not treated as a part of the Petitioner's gross income from the various properties upon which its percentage depletion allowances were based.

These authorities sufficiently illustrate the restricted meaning which has been authoritatively placed upon "gross income from the property" and require that the correlative phrase "net income of the taxpayer * * * from the property" be similarly limited to operating revenue derived from producing oil and gas from the property. This comes within the familiar doctrine that the coupling of words together show that they are to be understood in the same sense. This principle, as applied in a tax case, is illustrated by *Massachusetts Mutual Life Insurance Company v. United States*, 288 U. S. 269. The provisions for taxing insurance companies contained in the 1921 Revenue Act and those later adopted provided that the gross income of life insurance companies be determined upon a cash basis. In the cited case the insurance company had accrued more than $500,000 as interest upon dividends set aside for policyholders and by them left to accumulate at interest, but it had paid out a much smaller sum as such interest. The Company contended that the interest so set aside but unpaid could be deducted in computing its income, even though its gross income was determined upon a cash basis. This Court denied this contention saying:

"Since the Company is required to treat inter-

est received on a cash basis, it ought not to have the privilege of accruing interest owed."

Likewise, here, since Petitioner's gross income from the property, upon which depletion is based, is limited to gross receipts from the sale of oil and gas,—gross *operating* revenue,—only *operating* expenses should be deducted in arriving at the correlative limitation on the allowance,—net income from the property.

The Respondent has heretofore contended that the rule of *expressio unius est exclusio alterius* is applicable, that the presence of the clause "computed without allowance for depletion" in the limitation provision requires that all other items deductible in computing net income under the basic taxing sections should be taken into consideration in the computation. But this argument assumes the basic point in controversy. That point is whether the limiting phrase means operating profit or the net income upon which the tax is based. If intangible drilling and development costs are operating expenses, or if "net income * * * from the property" is synonymous with "net income" in Section 21, then without resort to the rule, the use of such costs in computing the limitation is clearly required. But the rule is of no aid in determining whether intangible drilling and development costs are or are not operating expenses, or whether "net income * * * from the property" is synonymous with the net income upon which the tax is based.

Again, the Respondent would apply that rule only to achieve the particular result sought here. He has not applied it as to other items deductible in arriving at net income under Section 21 of the Act, as will be developed more fully hereafter.[27] Nor does he apply it in determining this Petitioner's "gross income from the property." The basis for the allowance is 27½ per centum of the gross income from the property "excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property."[28] The *expressio unius* rule, as the Respondent would apply it when it is to his advantage, would require that an amount equal to rents and royalties paid would be all of the gross income as defined in Section 22 which would be excluded from the primary depletion base. Yet, from 1926 to date, the Respondent has limited that phrase to the gross income from the sale of oil and gas and has excluded therefrom many items which are gross income under the basic taxing sections, other than "an amount equal to rents and royalties" and he has been upheld in so doing.[29]

Summarizing, we say that gross income from the property, as used in *Section 114 (b) (3)* means gross operating revenue,—gross receipts from the sale of oil and gas,—that it is not synonymous with gross

---

[27]See pp. 35 to 37, infra. Bad debts and interest are items which he does not take into consideration.

[28]See p. 16, supra.

[29]See pp. 15 to 24, supra.

income as defined in the basic taxing sections, that this alone requires that only true *operating* expenses be deducted from such gross income to arrive at the net income of the taxpayer from the property, and that items which are not operating expenses should not be considered, though they are deductible in computing taxable income.

II.

Are such intangible drilling and development costs an expense of *operating* an oil property? If not, then, as heretofore shown, they do not enter into the computation of the percentage depletion limitation.

The differences between the parties are not as broad as might appear. The Respondent will not contend that in every case such intangible drilling and development costs are operating expenses. He will admit that unless a taxpayer has elected to charge off those costs in computing taxable income, he will not require them to be taken into account in calculating the depletion limitation. But he will say that, because these intangible costs were deducted in arriving at taxable net income they must be deducted in calculating the depletion limitation. So the actual point of difference between the parties may be thus stated: Does the fact that this Petitioner elected, when it began business in 1925, to charge off currently its intangible drilling and development costs and agreed that it would consistent-

ly follow this practice in all subsequent years and was thus *required* in the year under consideration to deduct such costs in computing its taxable income, make such costs a part of the expense of *operating* its properties?[30]

Under Regulations promulgated to enforce the Revenue Act of 1918,[31] oil operators were given the option to charge off currently intangible drilling and development costs, or to capitalize them and treat them as additional cost of the property for all purposes. The distinction between operating and other profits was not important under this Act,[32] and the Regulations provided that under this election these costs should be treated as an "operating expense." The Regulations provided "an election (to charge off or capitalize such costs) once made under this option will control the taxpayer's returns *for all subsequent years.*" The 1921 Act limited depletion allowances (when based on discovery value) to the taxpayer's net income from the property, computed without allowance for depletion, and thus it became important to determine what items deductible in computing taxable income were operating expen-

---

[30]It should be noted that, in his schedule, the Respondent did not include these costs with "production expenses" but classified them as "development expenses" (R. 18-A).

[31]See footnote 2, p. 5, supra.

[32]Since there was no limit upon allowable depletion.

ses.[33] So, in *Regulations 62*[34] it was provided that if a taxpayer had elected to charge off such intangible costs they might be deducted as a *development expense*, whereas, the earlier Regulation, when the question was unimportant, had classified them as an *operating expense*. This classification of those items as a development expense was continued from the 1921 Act down to Regulations 77 (1932 Act) when the word "development" was eliminated. Thus the Commissioner's original determination, continued for eleven years and not yet expressly revoked, was that such items are not operating expenses.

We are not here concerned with the authority of the Respondent to grant and continue for 21 years, and under nine major revisions of Income Tax Laws, the option either to charge off or capitalize such costs. Neither party presents that question here.

It is entirely erroneous to consider this matter as if this Petitioner had made its election to charge off intangible drilling and development costs in the year here involved. In this particular year this Petitioner had no election whatsoever as to how it would treat such costs,[35] but was *required* to charge them off be-

---

[33]The Regulations under the 1921 Act, directed that the limitation should be computed by deducting "operating expenses, including depreciation on equipment and taxes, but excluding any allowance for depletion" from "gross income from the sale of all mineral products and any other income incidental to the operation of the property". Art. 201(h) Reg. 62 (1921 Act) Appendix, p. 88, infra.

[34]Reg. 62, Art. 223 (1921 Act).

[35]This point is further developed, pp. 76 to 78, infra.

cause of its prior election to follow this practice. The established policy of the Treasury when this election was made, as will hereafter more fully appear, was not to take such costs into consideration in determining the depletion limitation.

We submit that there are but two possible constructions of the provision here under consideration. One construction is that, as originally ruled by the Treasury Department under the 1921 Law, the limitation is to be calculated by deducting from gross income from the property "operating expenses, including depreciation on equipment, and taxes, but excluding any allowance for depletion." Under this view to support his present practice the Respondent must establish that intangible drilling and development costs are "operating expenses". To refute any such contention, we have, as above shown, his own determination that even when a taxpayer elects or is required because of a prior election to charge off such costs in computing his taxable income, they are to be deducted, not as an operating expense, but as a development expense. This alone contradicts any contention which the Respondent might make that charging off such costs, in computing taxable income, changes the nature of the expenditure and converts it into an operating expense, and it would seem to require no argument to establish the fact that the cost of drilling and equipping oil wells does not come within the meaning of the word "operating" in ordinary parlance any more than the building and

equipping of a factory comes within the meaning of the term "manufacturing".

The only other position left open to the Respondent is that the proper construction of the depletion section requires that all items except depletion, which by statute are deductible in computing taxable income and which are related to the property, are to be deducted from "gross income from the property" in arriving at "net income from the property." These items which are by the statute deductible are set out in detail in Section 23 of the Law, and the basic taxing sections provide, in substance, that net taxable income (Section 21) is to be arrived at by deducting from gross income, as defined in Section 22, the items specified in Section 23.[16] The soundness of such a position may be tested by determining whether or not the Respondent's Regulations direct that such a method be followed and whether or not in actual practice he has followed such a method.

The deductions specified in Section 23 may be briefly summarized as follows: Ordinary and necessary expenses, including a reasonable allowance for salaries, etc.; interest; taxes; losses sustained and not compensated for by insurance; bad debts; depreciation; depletion; contributions to pension trusts for employees, all with exceptions not necessary to mention here.

The Respondent's Regulations have never directed

[16]These sections are shown in skeleton form in the Appendix, pp. 83, infra.

that all such items, even when related to the property, be deducted in computing the depletion limitation. As heretofore shown, the question first became important under the 1921 Act, and the Respondent's Regulations under that Act provided that the net income from the property was:

> "The gross income from the sale of all mineral products and any other income incident to the operation of the property for the production of the mineral product, *less operating expenses*, including depreciation on equipment and taxes, but excluding any allowance for depletion."[37]

The phrase was defined in the same language in Regulations adopted under the 1924 Act.[38] Under the 1926 Act the last phrase in the sentence was expanded to read:

> "* * * Less the deductions in respect to the property upon which the discovery is made, including operating expenses, depreciation, taxes, *losses sustained*, etc., but excluding any allowance for depletion."[39]

In the Regulations under the 1928 Law this "less" clause was again expanded to read:

> "* * * Less the deductions in respect to the property upon which the depletion is claimed, including overhead and operating expenses, development expenses (if the taxpayer has elected

---

[37]Reg. 62, Art. 201(h).

[38]Reg. 65, Art. 201(h).

[39]Reg. 69, Art. 201(h).

to deduct development expenses), depreciation, taxes, losses sustained, etc., but excluding any allowance for depletion."[40]

The deductible items as specified in *Regulations 77*, adopted under the 1932 Act, follow the 1928 Regulation.[41]

Two things appear from an examination of these Regulations. The first is that, without any supporting change in the statutory language, the Respondent has attempted to expand the items which are to be taken into consideration in computing the depletion limitation so, between the 1921 and 1932 Acts it has grown from a simple "less operating expenses, including depreciation on equipment and taxes, but excluding any allowance for depletion" to the enlarged and complicated provisions set out in Regulations 77, Art. 221(h), Appendix, p. 95, infra. The second is that, even under this progressive (and unauthorized) expansion there are items closely related to the property which are deductible in computing net income, but which are not included in the deductions required by later regulations. These include bad debts, the portion of overhead expense attributable to acquiring properties and other activities thereon, losses through failure of title, interest and other deductible items. (If the Commissioner is now taking interest into consideration, it is only a recent and

---

[40]Reg. 74, Art. 221(i).

[41]Reg. 77, Art. 221(h).

unauthorized innovation not mentioned in current regulations.)

Nor do we believe that the Respondent will, or can, successfully assert that his practice, as distinguished from his regulations, in computing the limitation has been to deduct from gross income from the property all of those items in any way related to the property which are deductible in computing taxable net income. We admit, or rather we charge, that the Respondent, after having established the practice under the 1921 and 1924 Laws of deducting only "operating expenses, including depreciation on equipment and taxes, but excluding any allowance for depletion" (Art. 201 (h) Regulations 62 (1921 Act), same Article Regulations 65, (1924 Act) Appendix, pp. 88 and 90, infra; G. C. M. 2315, Appendix, p. 97, infra, has in Regulations and practice attempted to enlarge the items which he deducts in computing the limitation, but he has never in practice or Regulations gone to the length to which he should go if he seriously contends that all items related to the property, and deductible in computing taxable income from all sources, are to be considered in computing the depletion limitation. In making this assertion we realized that the policy of encroachment and enlargement begun before this controversy arose has, perhaps, not been discontinued, and that the Respondent might be able to point to cases pending in his Department in which he is now taking such an extreme position. Our only answer to that possibility is that it does not represent a

settled policy, but illustrates the principle that even in the field of taxation if there is an appeasement by conceding one unauthorized demand, the recipient of the concession very frequently sets about to obtain additional concessions.

Again summarizing; The cost of developing and equipping an oil property is entirely distinct from the operation of such a property. Even when a taxpayer is required to charge-off intangible drilling and development costs in computing taxable income, the Respondent classifies such a deduction as a development expense, as distinguished from an operating expense. As shown in the previous subdivision of this argument, only operating expenses are to be deducted in computing the depletion limitation. The fact that intangible drilling and development costs may be charged off in computing taxable income from all sources cannot convert such costs into an operating expense. The only other position which the Respondent can take is that in computing the limitation all items related to the property, and which are deductible in computing a taxpayer's net income from all sources, must be taken into consideration, and that this position is not tenable is established by the Respondent's own regulations and practice.

Thus, without relying upon the legislative history of the question which will be dealt with next, and which standing alone would require that Petitioner's position be upheld, we submit that the intangible

drilling and development costs expended by Petitioner in the tax year involved here cannot be taken into consideration in computing its percentage depletion limitation.

III.

Any doubt as to the correctness of Petitioner's construction of the percentage depletion limitation provision of the 1932 Act is removed when the legislative history of the question is considered. This history is unusually clear, complete and convincing.

In 1918, Congress provided for depletion based upon the value of an oil property at the date oil was discovered thereon, or within thirty days thereafter. This allowance was to be used in lieu of depletion based on cost or value as of March 1, 1913, where it advantaged the taxpayer.[42] This allowance was not limited to the income from the property, or otherwise. Having fixed the discovery value and the estimated reserves of oil, the operator's discovery depletion allowance was arrived at by dividing the reserves into the value and multiplying the depletion unit so obtained by the number of barrels produced in the tax year.

Under the same Act, the Respondent adopted Regulations providing for the optional treatment of intangible drilling and development costs, heretofore discussed, and providing there that once the option had been exercised the practice adopted should be

[42]Secs. 214(a)(10) and 234(a)(9), Rev. Act of 1918.

continued in all subsequent years. He has continued this option and requirement under all later Acts.[43]

In the 1921 Act Congress continued the allowances for depletion contained in the Revenue Act of 1918, but provided that when depletion was based upon discovery value, the allowance "shall not exceed the net income (computed without allowance for depletion) from the property upon which the discovery is made."[44] This was the first use in revenue legislation of the phrase "net income (computed without allowance for depletion) from the property." Under this Act the Respondent adopted Regulations defining this net income as:

> "The gross income from the sale of all mineral products and any other income incident to the operation of the property for the production of the mineral products, less *operating expenses*, including depreciation on equipment and taxes, but excluding any allowance for depletion."[45]

In the same Regulations he provided that those who elected to charge off intangible drilling and development costs could deduct them in computing net income as a *development expense*, whereas, in the Regulations under the 1918 Act, when the question of net income from the property was unimportant, he had provided that these costs could be

---

[43]See footnote 2, page 5, supra.

[44]Secs. 214(a)(10) and 234(a)(9) Rev. Act of 1921.

[45]Reg. 62, Art. 201(h).

deducted as *operating expenses.*[46] Under the 1921 Act the Commissioner consistently followed the practice of not taking intangible drilling and development costs, even though charged off and deducted in computing taxable income, into consideration in computing discovery depletion allowable.[47]

When the Revenue Act of 1924 was before Congress a representative of the Treasury Department appeared befort the Committees considering the Bill and recommended that the limitation upon discovery depletion be increased.[48] He stated that the existing law limited the allowance "to *operating profit* from the property upon which the discovery is made"; that the draft of the law proposed by the Treasury limited the allowance to "50 percent of the *operating profit* (from the property) upon which the discovery has been made" and that "experience in administering the law has shown that the limitation imposed by the existing law is not a sufficient limitation, and it has been considered that 50 percent of the *operating profit* from the property represents a fair limitation upon discovery depletion." The Treasury's views were accepted and the section of the law modified to provide that:

---

[46]See p. 29, supra.

[47]G. C. M. 2315, VI-2, C. B. p. 21.

[48]"Statement of the changes made in the Revenue Act of 1921 by the Treasury Draft (of the 1924 Act) and the reasons therefor," made by A. W. Gregg, Special Assistant to the Secretary of the Treasury. See Appendix, p. 101, infra.

"Such depletion allowance based on discovery value shall not exceed 50 percentum of the net income (computed without allowance for depletion) from the property upon which the discovery was made."[49]

In adopting this phraseology, the *Report of the Senate Finance Committee* stated:

"The *existing law limits discovery depletion to operating profit* from the property upon which the discovery is made. The Bill limits discovery depletion to 50 percent of the *operating profit* from the property upon which the discovery has been made."[50]

Thus we have a plain recognition by the Treasury Department that the phrase "net income from the property, etc." mean operating profit, into the calculation of which intangible drilling and developments costs did not enter. We have a report of this construction to the appropriate Committees of Congress with a recommendation that the limitation as thus construed be increased, and we have the express approval of the Treasury's views and the adoption of them by Congress.

Under the 1924 Act the phrase was construed and applied in precisely the same way that it has been under the 1921 Law, except that the limitation was

---

[49]Sec. 204(c) Rev. Act of 1924.

[50]Report No. 398, p. 20 (Senate Finance Committee, 68th Congress, First Session). See also Appendix, p. 101, infra.

changed in accordance with the statute to 50 percent of the operating profit.[51]

The application of the discovery depletion provisions of the 1918, 1921 and 1924 Laws gave rise to serious administrative difficulties and, primarily to avoid those difficulties, there was substituted in the 1926 Law for discovery depletion the provisions for percentage depletion with which we are here concerned. This Court has said that in making this change it was not the purpose of Congress "to break with the past and narrow the function of that allowance."[52] The correctness of this is emphasized by the fact that the limitation was expressed in the language of the 1924 Act, "such allowance shall not exceed 50 percentum of the net income of the taxpayer (computed without allowance for depletion) from the property,"[54] and that, in commending this legislation to Congress, the Committee Reports stated that "the discovery depletion deduction *limitation*" of the earlier Act "*is retained.*"[55] The Treasury recognized this retention for they continued to calculate the limitation as they had under the 1924 Act.

So it appears that the Treasury had, prior to the passage of the 1926 Law, reported to Congress that

---

[51]G. C. M. 2315, VI-2, C. B. 21.

[52]U. S. v. Dakota-Montana Oil Co., 288 U. S. 459-467.

[54]Sec. 204(c)(2), Rev. Act of 1926.

[55]S. Rep. No. 52, p. 17, Senate Finance Com., H. Rep. No. 356, p. 32, Conf. Report 69th Congress, First Session—See Appendix, pp. 101-102, infra.

the depletion limitation was based upon operating profit, (into the calculation of which drilling costs did not enter), Congress had approved this and, when percentage depletion was substituted for discovery depletion, this depletion limitation was "retained." The initial practice under the 1926 Act was the same as that followed under the earlier Acts. Thus, in passing and enforcing the first Act providing for percentage depletion there was a recognition by Congress and the Treasury that intangible drilling and development costs should not enter into the calculation of the depletion limitation.

This continued without question until September, 1927, when an incident occurred to which the Respondent and the Fifth Circuit attach considerable importance, but which, we say, is important only because it confirms our statement as to what the practice was up to that time. The opinion of the Respondent's General Counsel was requested "as to whether development expenditures made in connection with oil or gas wells should be deducted from gross income of a discovery property in determining the net income from the property" within the meaning of the depletion limitation provisions of the Revenue Act of 1921, where the taxpayer elected to deduct such expenditures in computing taxable income.[57] The General Counsel stated that the question was given consideration:

"* * * shortly after the enactment of the

[57] G. C. M. 2315, VI-2, C. B. p. 21, set out in full in the Appendix, p. 97, infra.

> Revenue Act of 1921 * * * and the decision was reached that the 'net income from the property' * * * should be computed without regard to development expenditures, that is, that development expenditures should not be treated as a deduction in computing the 'net income from the property' regardless of whether the taxpayer corporation under Article 223 of Regulations 62 elected to treat such expenditures as operating expenses deductible in computing taxable income or to charge them to capital returnable through depletion."

The General Counsel went on to rule that in view of that early decision and the desirability of consistent administration, this provision of the Revenue Act of 1921, as well as the corresponding limitation of the Revenue Act of 1924, should be computed without regard to development expenditures, though deducted in computing taxable income. This, we submit, is the important portion of this opinion for, though it is only the opinion of the Commissioner's attorney and does not represent the views of the Treasury Department, as do Regultions and Treasury Decisions,[58] it is an admission that up to that time *and thereafter* the depletion limitation provisions of the Revenue Acts of 1921 and 1924 were construed and applied as we have heretofore stated.

But the General Counsel also volunteered the opinion that under the 1926 Act "the term 'net income' as used in that section should be taken to

---

[58]Helvering v. New York Trust Co., 292 U. S. 455, 468.

mean the net income defined in *Sections 212 and 323* of the Act," and that if a taxpayer elected "to treat development expenditures as ordinary and necessary business expenses deductible under Section 214 (a) (1) or 234 (a) (1) in computing net income, such expenditures must be deducted in computing the net income from the property, which amount is used as a limitation in the computation of the depletion alowance based on income." As to the opinion so volunteered by the Respondent's attorney, we have this to say: The taxing statutes and the decisions attach importance only to official Regulations and Treasury Decisions because these alone comply with the statutory requirement that Regulations be approved by the Secretary of the Treasury. The Bureau of Internal Revenue recognizes this, for in the bulletins in which such rulings are published it is stated:

> "The rulings reported in the Internal Revenue Bulletin are for the information of taxpayers and their counsel as showing the trend of official opinion in the administration of the Bureau of Internal Revenue; *the rulings other than Treasury Decisions have none of the force or effect of Treasury Decisions and do not commit the Department to any interpretation of the law which has not been formally approved and promulgated by the Secretary of the Treasury.* * * * Officers of the Bureau of Internal Revenue are especially cautioned against reaching a conclusion in any case merely on the basis of similarity to a published ruling, and should base

their judgment on the application of all pertinent provisions of the law and Treasury Decisions to all the facts in each case. * * *"

This Court quoted from this precautionary notice in *Helvering v. New York Trust Company*, 292 U. S. 455, 468, and since the rulings involved in that case were not expressly called to the attention of Congress, gave no weight to them in construing the taxing law under consideration.

The Bureau of Internal Revenue evidently followed the suggestion of its General Counsel in determining a deficiency under the Revenue Act of 1926 against Ambassador Petroleum Company, for that company took its case for the year 1925[59] to the Board of Tax Appeals and submitted this question to the Board for consideration. *(Ambassador Petroleum Company v. Commissioner*, 28 B. T. A. 868, decision promulgated August 8, 1933). The Board sustained the Commissioner's position and the case went on to the Circuit Court of Appeals where it was reversed, (81 Fed. (2d) 874). These two decisions will be discussed more at length hereafter,[60] but it should be noted here the Circuit Court of Appeals stated in that opinion that the Respondent conceded that it had been the practice prior to September 26, 1927, "to disregard development expenses in computing 'net income from the property' ", and that on the Commissioner's admission they were entitled to

---

[59]The calendar year 1925 was governed by the Revenue Act of 1926.

[60]pp. 71 and 75, infra.

infer that he interpreted the provision in the same way in all cases arising under the 1926 Act as he had done under the earlier Acts, except in the case of the Ambassador Petroleum Company. And, since the Commissioner sought no further review of the Ambassador decision, it necessarily follows either that he thereafter applied the section to other cases arising under the 1926 Act in accordance with the ruling of the Ninth Circuit Court of Appeals, or he disregarded the express holding of the only Appellate Court which has ever construed that provision of the Revenue Act of 1926.

There is nothing in the reports, or the other published proceedings, indicating that when the Revenue Act of 1928 was before Congress their attention was called to the General Counsel's Memorandum above referred to, or to the depletion question now under consideration. The 1928 Act readopted the percentage depletion section of the 1926 Act in identical language.[61] But it did give some consideration to depletion generally for there was added to the general depletion section a provision directing how depletion should be apportioned between life tenant and remanderman, and between trustee and beneficiary.[62] In spite of the fact that the Treasury Department did not call the attention of the Congress to *G. C. M. 2315*, or then evidence any desire "to break with the past and narrow the function of that allowance" by taking, in cases like

[61]Sec. 114(b)(3) Rev. Act of 1928.

[62]Sec. 23(l), Rev. Act of 1928.

this, development costs into consideration; in *Regulations 74*[63] promulgated under the 1928 Act, it was ruled that the net income of the taxpayer, etc., meant the gross income from the sale of oil and gas less the deductions in respect to the property upon which depletion is claimed, including overhead and operating expenses, development expenses (if the taxpayer has elected to deduct development expenses), depreciation, taxes, losses sustained, etc., but excluding any allowance for depletion. This Regulation, promulgated on the 15th day of February, 1929, was the first official statement that the Treasury Department was attempting to change its position on the question here involved.

Congress did not consider, or have its attention called to this depletion limitation question when it considered and passed any of the Revenue Acts subsequent to that of 1928. The language of the percentage depletion section, as contained in the Revenue Acts of 1926 and 1928, was continued in the 1932 Law, and in all subsequent Revenue Acts with the single addition in the Revenue Act of 1932 heretofore referred to.[64] In auditing cases under the 1928 and later Acts, the Bureau took intangible drilling and development costs into consideration in computing the depletion limitation, and many cases questioning that practice were carried to the Board of Tax Appeals. That body has, since the Ninth

---

[63]Art. 221(i), Appendix, p. 92, infra.

[64]See p. 15, supra.

Circuit's decision in the *Ambassador case*, consistently followed it.[65]

The tax year here under consideration is the fiscal year ended January 31, 1932. Because of an unusual provision in the Revenue Act of 1932, it was made applicable to all fiscal years ending in 1932. Thus this Petitioner's tax liability is to be determined under this Act, although it was introduced in Congress subsequent to the time its fiscal year ended, and its effective date was June 6, 1932, sometime after this Petitioner's tax return for the period here involved was due. The Regulations promulgated under the Revenue Act of 1932, which purported to require that "development costs properly charged to expense" should be taken into consideration in computing the depletion limitation, were not promulgated until February 10, 1933, more than a year subsequent to the closing of this taxpayer's fiscal year. Thus at the time Petitioner's tax return was due the only official expression of the Treasury Department purporting to require this taxpayer to take intangible drilling and development costs into consideration in computing its depletion limitation was that contained in *Regulations 74*, (1928 Act) which, for the first time, provided for a procedure directly contrary to that which had been followed since 1921, and which had been approved by the

[65]Mountain Producers Corp., 34 B. T. A. 409; Wilshire Oil Company, 35 B. T. A. 450; Ralph W. Crews, 37 B. T. A. 387; Rocky Mountain Oil Company, 36 B. T. A. 365; I. Rudman, 36 B. T. A. 803; Ortiz Oil Company, 37 B. T. A. 656; Hunt Production Company, 38 B. T. A. 457.

Congress in adopting the Revenue Acts of 1924, 1926 and 1928.

The *Ambassador Petroleum Company case*, 81 Fed. (2d) 474, was decided by the Ninth Circuit on April 4, 1936. This was more than two months before the Revenue Act of 1936, containing the provision for limiting the percentage depletion allowance, was approved. The Revenue Act of 1938, which likewise contained the same language, was approved May 27, 1938. Between the passage of the 1936 Act and the 1938 Act the Respondent had failed to take to seek a further review in the *Ambassador Petroleum Company case;* the Board of Tax Appeals had followed that case in the *Wilshire Oil Company* case. decided February 10, 1937, and in numerous other cases, and the Ninth Circuit Court of Appeals had affirmed the *Wilshire Oil Company* case (95 Fed. (2d) 971), decided on April 1, 1938.

Thus this legislative history shows:

(1) The principle of limiting discovery depletion to net income from the property was adopted in the Revenue Act of 1921.

(2) The Bureau of Internal Revenue promptly held that only operating expenses were to be considered in computing "net income from the property, etc.," and that intangible drilling and development costs, though charged off in computing taxable income were not "operating expenses" to be considered in this calculation.

(3) This practice and construction was reported to and approved by Congress when it passed the Revenue Act of 1924, and at the Treasury's request increased the limitation. The method of calculation adopted under the 1921 Act was continued under the 1924 Act.

(4) In 1926 Congress substituted percentage depletion for discovery depletion to remove administrative difficulties, without intending to narrow the scope or function of the allowance, and expressly continued the depletion limitation provisions of the earlier Acts.

(5) Until September, 1927, no question arose as to the correctness of the practice initiated under the 1921 Act. The ruling of the General Counsel for the Bureau of Internal Revenue, promulgated September 26, 1927, (G. C. M. 2315) was never approved by the Secretary of the Treasury and was not authoritative. There is authority for stating that under the 1926 Act, no taxpayer, other than Ambassador Petroleum Company, was subjected to the burden of that ruling.

(6) When the 1928 Act was passed the attention of the Congress was not directed to the aforesaid ruling of the General Counsel. The percentage depletion limitation section received no specific consideration, and Congress continued in precise terms the language of the 1926 Act.

(7) *Regulations 74*, adopted under the 1928 Act, on the 15th day of February, 1929, purported to

require that if a taxpayer deducted intangible costs in computing taxable income, they should be taken into consideration in computing the depletion limitation. This change in position occurred after seven years of consistent administrative practice to the contrary, and after that practice had been twice expressly, and once inferentially, approved by Congress.

(8) This Petitioner's tax year here involved closed before the Revenue Act of 1932 was adopted and more than a year before the promulgation of Regulations under the 1932 Act, which purported to continue the practice initiated in the 1928 Regulations.

(9) The attention of Congress was not directed to the attempted change in practice when the 1932 and 1934 Acts were passed and the depletion limitation language continued.

(10) When, on June 22, 1936, the 1936 Law was passed with the same language, the Ninth Circuit Court of Appeals, the only Court which had ever spoken upon the subject, had expressly held that under the 1926 Law, it was not proper to consider intangible drilling costs in computing the depletion limitation.

(11) When the 1938 Act was passed, on May 27, 1938, continuing the language here under consideration, the Ninth Circuit Court of Appeals had again ruled in the same way as to a case under the 1928 Act, and the Board of Tax Appeals had applied the

same principle in numerous cases under the 1928, 1932 and later Acts.

We submit that by settled principles of construction, this history of the question requires that the phrase "net income of the taxpayer, computed without allowance for depletion, from the property" in the Revenue Act of 1932, be construed and applied as it was under the 1921 and 1924 Acts, and therefore, intangible drilling and development costs, though charged off in computing taxable income, do not enter into the calculation.

We start with the premise that this language and the related language "gross income from the property" were sufficiently ambiguous to require construction and interpretation by the Department charged with its enforcement,[66] and that the original construction placed upon the limiting language under the 1921 Act was a reasonable construction.

---

[66]In Walker v. U. S., 83 F. (2d) 103, 106, the Sixth Circuit states the rule thus:—"If the statutory meaning is clear, there is no place for rules which aid in ascertaining the meaning of the statute, and neither legislative nor executive construction nor both is of any aid or force. Mass. Mutual Life Ins. Co. v. U. S., 288 U. S. 269, 273; L. & N. R. Co. v. U. S., 282 U. S. 740-757; Iselin v. U. S., 270 U. S. 245, 251. However, if the Act is ambiguous (Mass. Mutual Life Ins. Co. v. U. S., 288 U. S. 269-273, L. & N. R. R. Co. v. U. S., 282 U. S. 740, 757; U. S. v. M. P. R. Co., 278 U. S. 269-281; Iselin v. U. S., 270 U. S. 245-251), the Courts will in their search for the proper meaning of the Act, give consideration to a later legislative construction (N. Y. P. & N. R. Co. v. Peninsula Exchange, 240 U. S. 34, 39), or to the construction by an executive for administrative or enforcement purposes. (U. S. v. Hamners, 221 U. S. 225-226-228-229)."

To support this, we say the Treasury must have so considered it, because they originally adopted that construction. Congress must have so considered it, because they expressly approved that construction when they passed the 1924 Act. The Ninth Circuit Court of Appeals so considered it, for they approved that construction.[67] The correlative phrase "gross income from the property" is ambiguous enough to have required interpretation by this Court in six cases,[68] in addition to the more numerous occasions upon which it has been considered and interpreted by the lower courts and the Board of Tax Appeals.

Thus, considering the matter as it was before the 1924 Act was passed, we start with the proposition that the construction by the Executive Department, charged with its enforcement, of ambiguous language contained in a statute is entitled to weight and respect and will not be overthrown except for compelling reasons.[69]

But the situation was much stronger after the 1924 Act was passed. When this construction of the 1921 provision was reported to Congress, expressly approved and the same language continued in the

---

[67]Ambassador Pet. Co. v. Com., 81 F. (2d) 474; Commissioner v. Wilshire Oil Co., Inc., 95 F. (2d) 971.

[68]See footnote 10, p. 16, infra.

[69]In Brewster v. Gage, 280 U. S. 327, this Court said: "It is the settled rule that the practical interpretation of an ambiguous or doubtful statute that has been acted upon by officials charged with its administration will not be disturbed except for weighty reasons."

1924 Act, that construction became as much a part of the law as if it had been expressly incorporated in the Statute. This Court has so held on numerous occasions.[70] What does that necessarily mean? We submit that, because of this rule, the provision of the 1924 Act that:

> "But such depletion allowance based upon discovery value shall not exceed 50 percentum of the net income (computed without allowance for depletion) from the property upon which the discovery was made."

means, and should be construed and applied as if it contained an express provision that intangible drilling and development costs should not be considered in computing the limitation.

What other effect and meaning can be given to this Court's often repeated statement that when a

---

[70]This is clearly stronger than a presumptive approval. In Hartley v. Commissioner, 295 U. S. 216-220, this Court said: "The reenactment of the pertinent provisions of Sec. 202 of the Revenue Act of 1921 in the Acts of 1924 and 1926, without material change, was a congressional recognition and approval of the interpretation of the section by the Treasury Regulations, *which gave them the force of law.* Old Mission Portland Cement Co. v. Helvering, 293 U. S. 289-293-294; Brewster v. Gage, 280 U. S. 327, 337." In the Old Mission Portland Cement Company case, supra, this Court said, at page 294: "As section 234(a)(1) to which they pertain has been reenacted in several acts, the regulation now has the force of law. McGaugh v. Hershey Chocolate Co., 283 U. S. 488-492; Mass. Mutual Life Ins. Co. v. U. S., 288 U. S. 269-273." See also the decisions of this Court collected at page 106 of Walker v. U. S., 83 Fed. (2d) 103.

departmental construction, is so reported to and approved by Congress, it "has the force of law."?

This position was strengthened by the adoption of the Revenue Act of 1926, and the clearly expressed Congressional intention to retain the discovery depletion limitation of the earlier Act. Here again, by retaining the discovery depletion limitation of the earlier Act, Congress has said that intangible drilling and development costs do not enter into the calculation of the depletion limitation.

If thus far the Petitioner's position is sound, then we must consider the right of the Treasury to make the change in Regulations here involved. In other words, if the Act had contained an express provision that intangible drilling and development costs should not be taken into consideration in computing the depletion limitation, could the Treasury, by regulations, or otherwise, require that they be taken into consideration? There would, in such event, be no ambiguity in the statute. It is settled that where there is no ambiguity, the Courts will not look to departmental construction or legislative history to guide them in declaring its meaning, and that no one charged with the execution of such an unambiguous law has any authority to depart from that

---

[71]Manhattan General Equipment Company v. Commissioner, 297 U. S. 129, 134, where this Court said:

> "The power of an administrative officer or board to administer a federal statute and to prescribe rules and regulations to that end is not the power to make law,

plain unambiguous meaning.[71] So, with the situation being as it was, General Counsel's Memorandum No. 2315, even if it has been validated by a Treasury Decision, could have no effect upon the question here under consideration. The same is true of the Regulations adopted under the 1928 Act. For the Treasury did not see fit to suggest to the Congress that it was changing, or was considering changing, its position and ask Congressional approval therefor. The situation after the 1928 Act was exactly what it would have been had the 1928 Act expessly prohibited the Taxing Authorities from taking intangible drilling and development costs into consideration.

The Commissioner will no doubt argue that principles akin to those which we have just discussed require a contrary conclusion because, after the noted change in the Regulations under the 1928 Act, Congress has used the language of that Act in the 1932, 1934, 1936 and 1938 re-enactments. But there are many reasons why these rules cannot be applied as the Commissioner would ask. We are dealing with a statute which is no longer ambiguous because the first construction of the Bureau had been incorpo-

---

for no such power can be delegated by Congress, but the power to adopt regulations to carry into effect the will of Congress as expressed by the statute. A regulation which does not do this, but operates to create a rule out of harmony with the statute, is a mere nullity. Lynch v. Tilden Produce Co., 265 U. S. 315, 320-322; Miller v. United States, 294 U. S. 435-439, 440, and cases cited."

rated therein.[73] The Commissioner cannot point to any occasion upon which the attention of Congress, or either of the appropriate Committees, was directed to the change in Regulations or the Treasury Department's dissatisfaction with the earlier rule. Insofar as this taxpayer's particular tax year is concerned, the 1932 Act, upon which the Commissioner must rely as the first approval of the 1928 Regulations, was passed several months after this Petitioner's tax year closed and its return was due. Such a construction would attach more importance to Treasury Regulations than would be attached to Court decisions like the *Ambassador and Wilshire cases*, in the light of which it must be held Congress continued to use in the 1936 and 1938 Acts the language of the 1926 Act thus authoritatively construed.

A closely related question was before this Court in *Helvering v. Reynolds Tobacco Company*, 306 U. S. 110, and was also decided by the Second Circuit in *E. R. Squibb & Sons v. Helvering*, 98 Fed. (2d) 69. The basic question in these cases was whether a corporation derived taxable income from dealings in its own stock. The *Reynolds Tobacco Company case* arose under the Revenue Act of 1928; that of *E. R. Squibb & Sons* under the Revenue Act of 1932.

Since 1920, Treasury Regulations had provided that a corporation realized no gain or loss from the

---

[73]See Manhattan General Equipment Company v. Commissioner, 297 U. S. 129-134, quoted from in footnote 71, p. 55, supra.

sale of its own stock. On May 2, 1934, this was changed, the substance of the change being that in case a corporation dealt in its stock, as it might in the shares of another, a taxable profit or loss might result. The Second Circuit, in the light of the long continued departmental construction approved by Congress, held:

> "* * * that the uniform interpretation so long placed upon paragraph 22(a) by the regulation and confirmed by the inaction of Congress, *was imbedded in the statute so deep that only legislation could dislodge it.*"

In the *Reynolds Tobacco Company* case, the Fourth Circuit, (97 Fed. (2d) 302), followed the same line of reasoning and the judgment there was affirmed by this Court. But it was not found necessary to determine how the question would be decided in cases which arose after the change in Regulations. In this respect, this Court said:

> "We need not now determine whether, as has been suggested, the alteration of the existing rule, even for the future, requires a legislative declaration or may be shown by reenactment of the statutory provision unaltered after a change in the applicable regulation. As the petitioner points out, Congress has, in the Revenue Acts of 1936 and 1938, retained Section 22(a) of the 1928 Act in *haec verba*. From this it is argued that Congress has approved the amended regulation. It may be that by the passage of the Revenue Act of 1936 the Treasury was author-

ized thereafter to apply the regulation in its amended form. But we have no occasion to decide this question since we are of opinion that the reenactment of the section, without more, does not amount to sanction of retroactive enforcement of the amendment, in the teeth of the former regulation which received Congressional approval, by the passage of successive Revenue Acts including that of 1928".

The fact that the 1932 Law was passed after this taxpayer's tax year was closed brings it within the spirit of this pronouncement against retroactive application of amended regulations.

If it is now necessary, in spite of actual retroactivity, to decide the question not determined in the Reynolds Tobacco Company case, then we submit that the change which the Commissioner has sought to effect by Regulations can only be accomplished by legislation. There is no reason to believe that Congress knew of the attempted change in Regulations. The matter was not brought to the attention of Congress after 1926. Viewing the realities of the situation, it strains credulity to assume that the Congress was actually cognizant of the attempted change in the 1928 Regulations. The language of the 1926 Act was judicially construed later, and thereafter, the language was used in the 1936 and 1938 Acts. Since this judicial construction ran counter to Regulations, it will be considered that the judicial, and not the changed departmental construction, was ap-

proved.[74] Certainly no rule which would require one construction under the 1926 Act and another under those of 1928 or 1932, and a return to the earlier construction under the Acts of 1936 and 1938, should be adopted. Although this Court did not find it necessary to pass upon this question in the *Reynolds Tobacco Company case*, its pronouncements heretofore noted require that the right of the Treasury to change its original construction, so approved by Congress and the Courts, must be denied. This necessarily follows from holding that the first and approved construction became a part of the law. If it did become a part of the law, it removed any ambiguity, and reason for construction, and to hold that administrative officers can thereafter change the Regulations is to confer upon those officers power to amend an Act of the Congress, to legislate, and, after having obtained express instructions from Congress upon a particular point, to depart therefrom whenever they see fit.

At least two Circuit Courts of Appeals have expressly so held. The *Squibb* case, decided by the Second Circuit has already been noted. The Sixth Cir-

---

[74] "But, when a Court has adopted such construction, it is not in the power or authority of the executive authority to change or alter that construction. Congress alone has power to change that construction by amendment of the statute itself. It follows therefore that when Congress has adopted an executive construction of a statute, that neither the department charged with its enforcement or the Courts have power to change that construction." Mayes v. Paul Jones Company (6th C. C. A.) 270 Fed. 121-130.

cuit, in *Mayes v. Paul Jones Company*, 270 Fed. 121-129, likewise held:

> "It is contended, however, on the part of the United States government, that it is not precluded from a change in construction by reason of a prior erroneous construction of a statute, although that erroneous construction has long been followed by the executive officers charged with the administration of the law. Undoubtedly that contention is correct as an abstract proposition. If there had been no later legislation upon this subject than the third subsection of section 3244, R. S., the Treasury Department, in the absence of judicial interpretation, would be at liberty to make such change in prior construction from time to time as would seem to it necessary to carry into effect the purpose and intent of the law; *but if by the Revenue Act of October 3, 1917, Congress has adopted a long-continued executive construction given to paragraph 3 of section 3244, R. S., the Treasury Department is no longer at liberty to change that construction.*"

Therefore, we say, using Judge Hand's language in the *Squibb case*, that, when Congress, in passing the 1926 Act expressly approved the depletion limitation provision of the prior Acts, as construed and applied, that construction became "imbedded in the statute so deep that only legislation could dislodge it." Neither the unsolicited opinion expressed in *G. C. M. 2315*, nor the attempted change in *Regulations 74*, is an effective substitute for such legislation.

IV.

There are three rulings and decisions which go contrary to the result for which Petitioner contends. These are *G. C. M. 2315*, C. B. VI-2, page 21, heretofore referred to; the opinion of the Board of Tax Appeals in the *Ambassador Petroleum Company case*, 28 B. T. A. 868, (reversed by the Ninth Circuit); and the opinion of the Fifth Circuit in the case at bar.

As to the opinion of the Fifth Circuit, we respectfully submit that the Court misconceived the whole problem, its background and history, as will appear from the following:

(a) That Court stated that the 1918 and 1921 Acts provided for depletion "based on cost" (R. 64); whereas, in fact, these Acts provided for depletion based on discovery value, as an alternate to depletion based upon cost or upon value as of March 1, 1913.

(b) That Court stated that the 1924 Act continued this allowance (i. e. "based on cost"), but with the limitation that the allowance should not exceed 50 per cent of the net income from the property, etc.; whereas, in fact, cost depletion has never been limited; the original limitation was on discovery depletion, it originated in the 1921, not the 1924, Act, which changed the maximum allowance from 100 percent to 50 percent of the operator's profit.

(c) That Court stated that the 1926 Act made a radical change as to the basis of computing the

depletion allowance; whereas, no change at all was made as to depletion based on cost or on value as of March 1, 1913, but percentage depletion was substituted for depletion based on discovery value, the "nature and functions of the allowances remaining the same."

(d) That Court stated that the Regulations promulgated under the 1926 Act "were silent as to the method of computing depletion by the percentage method"; whereas, *Art. 221 of Regulations* 69 (1926 Act), Appendix, p. 91, infra, dealt with that subject. It is true that this Article does little more than repeat the statutory language, but this statutory language, as heretofore shown, had already acquired through departmental construction and legislative approval a meaning directly opposed to that which the Court below placed upon it.

(e) That Court stated that, under the 1924 Act the Commissioner "had ruled that *net income* meant net operating revenue and had excluded development costs in computing it"; whereas, the ruling was first made under the 1921 Act and was continued, with express Congressional approval, under the 1924 Act.

(f) That Court stated that this practice was continued "for awhile under the 1926 Act, but changed (by G. C. M. 2315) on September 26, 1927, and the present practice adopted"; whereas, *G. C. M. 2315* did not require a change of practice by Bureau

officers,[76] there is nothing to show when, if ever, the practice was changed as to cases arising under the 1926 Act, and another Court has stated that, insofar as appeared, the practice was not followed as to any such case except that of *Ambassador Petroleum Company.*[77] The *first official attempt to change position* was on February 15, 1929, when *Regulations* 74 (1928 Act) were promulgated.

(g) That Court stated that the Respondent's decisions under the previous Acts "were certainly not approved by the enactment of the 1926 Act"; whereas, they were expressly approved when the 1924 Act was passed, and in adopting the 1926 Act, Congress expressly retained the depletion limitation provisions of the earlier Act.[78]

(h) That Court stated that the short time during which the Respondent followed his earlier practice under the 1926 Act would not estop him from changing if convinced he was wrong; whereas, it is not a question of estoppel, he made no change in his position under the 1926 Act, or until *Regulations 74* were adopted, the practice actually continued from 1921 until February 15, 1929, (except as noted above in (f)) and Respondent has no power to change an interpretation after Congress has approved that interpretation and thus made it a

[76]Helvering v. N. Y. Trust Company, 292 U. S. 455-468.

[77]Ambassador Petroleum Company v. Commissioner, 81 Fed. (2d) 474, 477, 480. See also: Commissioner v. Wilshire Oil Company, Inc., 95 Fed. (2d) 971-974.

[78]See page 41, supra.

part of the statutory law, whether or not he thinks the law wrong.[79]

(i) That Court stated that the rule of *United States v. Dakota-Montana Oil Company*, 288 U. S. 459, as to legislative approval of departmental construction, supported the Respondent's right to change his practice; whereas, no change of position by the Taxing Authorities was there involved,[80] and the doctrine that legislative approval of departmental construction makes that construction a part of the law requires the holding that, after such legislative approval, only Congress can make a change.

(j) That Court stated that the decision of the question did not depend upon the application of this rule; whereas, when the construction which a Department charged with its enforcement has placed upon a statutory provision is called to the attention of Congress, and, thereafter, the statutory provision is reenacted, all questions as to the correctness of the original interpretation are foreclosed, and such interpretation becomes so deeply imbedded in the law that only legislation can remove it.

(k) That Court stated that, before the 1926 Act,

---

[79]See page 54, supra.

[80]"Thus the Acts of 1918, 1921 and 1924 were consistently construed by the Regulations * * *. The administrative construction must be deemed to have received legislative approval by the reenactment of the statutory provision, without material change." U. S. v. Dakota-Montana Oil Company, 288 U. S. 459-466.

if development costs were deducted (in computing taxable income) they could not thereafter be added to increase the basis for depletion; whereas, we have no direct concern here with a depletion base; we are concerned with the method of calculating the limitation upon the amount otherwise allowable when based on gross income from the property. Development costs, though charged off, did not limit the allowance when based on discovery value, Congress intended that the same method should be followed when the allowance was based upon gross income from the property. This intention controls.

(l) That Court stated that nothing indicated that Congress intended that different methods should be followed after percentage depletion was substituted for discovery depletion; we agree. But Respondent, not Petitioner, is attempting to change the earlier procedure.

(m) That Court stated that the deduction of drilling costs reduces the net income upon which the tax is assessed. True, but the Respondent intended this result, he has never questioned it. It does not authorize an improper calculation of the depletion limitation.

(n) That Court stated that "if development costs are excluded in computing net income in those instances where 27½ percent of the gross income exceeds 50 percent of the net income, they enter into and add to the basis for depletion"; whereas, in fact the basis for the allowance is gross income from

the property, which is neither increased or diminished by development costs, whether charged off or capitalized.

(o) That Court stated that "net income computed without allowance for depletion" means what is left after every allowable item, except depletion, is deducted from "gross income"; whereas, the Bureau has never before contended for or applied so broad a construction, and many items, related to the property and deductible in computing taxable income, are not considered in computing the depletion limitation, as, for example, bad debts, losses for casualties or failure of title, interest, etc.

(p) That Court stated that the change in Regulations 74 and in subsequent Regulations was reasonable and fair; whereas, when Petitioner elected to charge off intangible costs and agreed to continue that practice in all subsequent years, it was a part of the bargain that these costs would not be considered in computing the depletion limitation, and at no time since Regulations 74 were adopted[81] has the

---

[81]In T. D. 4025, approved by the Secretary of the Treasury on June 18, 1927, (C. B. VI-1, p. 75, after calling attention to the option granted in Art. 223 of Regulations 69 (1926 Act) to deduct intangible drilling and development costs, and the corresponding option granted under the Revenue Acts of 1918, 1921 and 1924, it was stated: "In view of the change in the basis for depletion provided by the Revenue Act of 1926, in the case of oil and gas wells taxpayers may make a new election as to the treatment of the expenditures above mentioned for taxable periods ending on or after January 1, 1925, but not later than six months after the date of this decision. Taxpayers desiring to make a new elec-

Respondent authorized Petitioner to change this election. Is it fair to hold one to a bargain, but draw back a portion of the consideration?

---

tion are required to file amended returns for the taxable periods involved within six months from the date of this decision."

G. C. M. 2315, heretofore dealt with, was issued in September, 1927. This G. C. M., coming some three months after the Treasury Decison above quoted from, was the first intimation given taxpayers that intangible drilling and development costs might not be taken into consideration in computing the depletion limitation.

We think it is clear that the promulgation of T. D. 4025 does not change the situation from what it would have been had this new election not been granted. The taxpayer was incorporated in 1925. In its first return it elected to charge off intangible drilling and development costs in computing taxable income. As elsewhere shown, one of the benefits expected from this option was that such costs would not be taken into consideration in computing the depletion limitation. Except for T. D. 4025, it was at all times thereafter bound to follow the practice which it had originally chosen. T. D. 4025 assigned as its reason for offering a new election the fact that the 1926 Law substituted percentage depletion for discovery depletion, but it contained no intimation that the previously well established practice of not taking intangible drilling and development costs into consideration in computing the depletion limitation would be changed. Petitioner had never operated under the discovery depletion provisions of earlier laws for, since it was incorporated in 1925, its first tax year and its election to charge off intangible drilling and development costs has been made under the provisions of the Revenue Act of 1926. Thus there was no reason for it, when T. D. 4025 was promulgated, to make a change. The later G. C. M. 2315 was not an official ruling. Petitioner was neither warranted nor authorized to rely upon it. See Helvering v. New York Trust Company, 292 U. S. 465, 468, and p. 45 hereof supra. With such in-

(q) That Court stated that the Regulations conform to the intention of Congress; whereas, on every occasion upon which the intention of Congress has been expressed, it was stated that the limitation should be based upon operating profit.

(r) That Court stated that, if intangible costs are deducted in computing net income, such items must be treated as all other items deductible in computing net income; whereas, we are concerned with computing the depletion limitation, not net income, and there is no rule or practice which requires that all of the items which are deductible in computing the net income upon which the tax is based are to be considered in computing operating profit or the depletion limitation. Some, because they are operating expenses, are so considered. Others, which are not operating expenses, are not taken into consideration.

Thus it seems clear that the Court below entirely misconceived two vital factors necessary to a correct decision of this case: (1) The legislative history,

---

formal rulings filling each year from five hundred to eight hundred printed pages of the published Internal Revenue Bulletins and with each containing a warning that no such ruling commits "the Department to any interpretation of the law which has not been formally approved and promulgated by the Secretary of the Treasury", it would be a harsh rule indeed which would charge a taxpayer either with actual or constructive notice of the contents of such rulings, or require that he govern his conduct by any particular one of them.

coupled with the length of time during which the original practice remained unquestioned, and, (2) incorrectly assumed that all items which are deductible in computing net income should be taken into consideration in computing the depletion limitation.

The *Ambassador Petroleum Company* decision by the Board of Tax Appeals (28 B. T. A. 868), later reversed by the Ninth Circuit Court, reached an erroneous conclusion primarily for the reason that the Board considered that, when percentage depletion was substituted in the 1926 Act for the discovery depletion provisions of prior Laws, Congress intended to break with the past, and that the language expressing the limitation should not be construed as had the same language in the earlier Acts.[82] This opinion does not give weight to the legislative history heretofore outlined, which is decisive.

In *G. C. M. 2315*, the General Counsel gave no weight to legislative history or to prior departmental construction, but briefly announced that the term "net income" as used in the depletion section should be taken to mean the net income defined in Sections 212 and 232 of the 1926 Act. Accordingly, he said that if a taxpayer elected to treat development expenses as ordinary and necessary business expenses in computing taxable net income, these expenses must be deducted in computing the deple-

[82]This is directly opposed to this Court's ruling in U. S. v. Dakota-Montana Oil Company, 288 U. S. 459-467.

tion limitation. It was only a matter of months until the General Counsel's attention was called to the inconsistency between the statement in *G. C. M. 2315* that net income from the property meant the net income defined in the basic taxing sections and his ruling in G. C. M. 1023 that the gross income from the property upon which the depletion was primarily based could not include income arising from the sale of property, or an interest therein, and he was forced to retract that portion of G. C. M. 2315, by saying that "gross income from the property" was "only to the net income derived on account of oil and gas produced from the property."[83]

The prevailing opinions in the *Ambassador* and *Wilshire* cases are much more persuasive. The principal opinion in the *Ambassador case* was written by Judge Garrecht with Judge Denman delivering a concurring opinion and Judge Wilbur dissenting. Judge Garrecht correctly stated the legislative history of the question and the Treasury's prior practices and, in the light of this, held that "net income from the property" and "operating profit" were synonymous, and "there is nothing in the Revenue Acts to suggest that 'development expense' should be deducted from gross income in order to arrive at 'operating profits;' nor does reason point to any such formula." He dealt with the *expressio unius* rule of construction relied upon by Respondent, approving the following from *25 R. C. L. 983*:

"The maxim is not of universal application,

[83]G. C. M. 5104. C. B. VII-2, p. 115.

but is to be applied only as an aid in arriving at intention and not to defeat the apparent intention."

He also refused to give any weight to the attempted change in the Regulations promulgated under the Revenue Act of 1928.

In concurring, Judge Denman said that the controlling factor was that net income of the taxpayer from the property meant operating income and was different from the taxpayer's general net income for final computation of the tax. He, too, dealt with legislative history and departmental practices, pointing out that the Respondent admitted that "prior to September 26, 1927, it had been the practice of the Commissioner to disregard development expense in computing the 'net income from the property' ", and that upon the record "we are entitled to infer he (the Commissioner) has interpreted the clause in the same way under the 1926 Act as under the earlier acts in *every case except that of the Ambassador Petroleum Company.*" (Italics by the Court). He pointed out that every objection urged to the construction sought by Ambassador Petroleum Company was equally applicable to the 1921 and 1924 Acts, but, nevertheless, Congress had approved the questioned interpretation. He relied upon the inequity of changing the method of computing the limitation and yet holding the taxpayer to his election with regard to intangible costs.

It seemed to be Judge Wilbur's view in dissenting

that by electing to charge off intangible drilling and development costs the taxpayer had thereby converted them into operating expenses. The fallacy of his position is made evident by the analogy which he attempted to draw between such an option and the items which a public utility might either deduct currently or capitalize. He referred to his concurring opinion in *Los Angeles, etc. Corporation v. Railroad Commission*, 58 Fed. (2d) 256, 257, and said:

> "We there held that the public utility company should not be permitted to shift its ground and claim that amounts apportioned to current expense and thus paid by the consumers, should be subsequently treated as a capital investment upon which compensatory rates should be allowed to the company."

But this does not support Judge Wilbur's primary position,—that is that drilling costs charged off become operating expenses. It would support the proposition that drilling costs charged off cannot later be capitalized and treated as a part of the cost of property for any purpose, but we do not have that question here.

We also submit that he misconceived the return of capital theory as applied to depletion. He evidently considered that because one reason which no doubt prompted Congress to provide for depletion allowances upon any base whatsoever was to return capital,—that is, the actual investment of the taxpayer in the asset so depleted,—this was the only

justification for any allowance for depletion. But both discovery depletion and percentage depletion were predicated primarily upon different theories and are most often applicable to those cases where an oil operator has little, if any, investment in the oil reserves. Both percentage depletion and discovery depletion were allowable, although the operator had actually no investment whatsoever in the oil reserves, and the primary reason why Congress provided for the allowances was to compensate for the hazardous nature of the business. In the light of this, it is apparent that Judge Wilbur was in error when he said:

> "It should be observed here that under the statutory formulae for ascertaining the depletion allowance, it is increased by treating the development expenditure as a capital investment, as it should be, because such capital must be recovered through the depletion allowance."

The formula simply does not work that way. It is true that if drilling costs are capitalized, they may be added to the basis for cost depletion and thereby the basis for cost depletion may be built up to where such an allowance exceeds the allowance based on gross income. When it does this the taxpayer may claim the larger allowance under express Congressional authority. But capitalizing intangible costs does not increase the percentage depletion basis. Judge Wilbur seemed to think that the method of computation approved by the majority allowed a 150% deduction in computing income for intangible

drilling and development costs, but, as will appear in another part of this brief, such an assumption is insupportable.

The *Wilshire* decision was likewise by a divided Court. Judge Denman delivered the majority opinion, in which Judge Garrecht concurred and Judge Wilbur briefly dissented.

The primary basis of the majority opinion was that:

> "When the 1928 taxing act here in question was passed, the law thus had been made plain that 'net income from the property' means net 'operating' income."

and that thereafter the Treasury Department was not at liberty to change its construction. As to the assertion that the actual practice of the Treasury was changed in 1927, before the 1928 Act was passed, and that Congress was deemed to have known of it, the majority opinion stated:

> "We have searched the record in vain for any proof of such a claimed practice. Much less is there anything within or without the record suggesting that Congress knew of such a practice. It certainly is not proved by attempting to have us consider the claimed 'General Counsel's Memorandum' 2315, published September 25, 1927, in which that counsel gave his unsolicited opinion, *in effect that the Congress and the Treasury were wrong when they interpreted net income as net 'operating' profit or income. The Commissioner's brief here lacks*

the candid admission of his brief in the case of Ambassador Petroleum Company v. Commissioner, etc."

The majority opinion also dealt with the alleged inconsistency in deducting capital expenditures from gross income and not deducting them from net income from a particular property. It was stated that this might be advantageous to the taxpayer in a particular year, but the "government may gain greatly in the future by the requirement that the taxpayer must always thereafter omit his *capital* development expenditures from his capital account. The fact that the *regulation* compelled such future accounting, implies that the Treasury contemplated such a beneficial result to its revenues."

We submit that the majority opinions of the Ninth Circuit in the *Ambassador* and *Wilshire* cases advance unanswerable arguments why the same decision should be reached in this case.

V.

This Petitioner's position presents substantial equities. It began business in 1925. It elected to charge off as development expenses intangible drilling and development costs and it thereby agreed that it would in all subsequent years follow that practice. When it made this election, it was the settled practice not to take such costs, though charged off, into consideration in computing the depletion limitation. It is implicit in the granting of such an election that a taxpayer will attempt to

forecast his future tax situation and will choose that one of the permitted methods which in the long-run appears advantageous. Equally it is implicit that from year to year there will be benefits or burdens which the use of the other method might have obviated. From the standpoint of the Government, but not from the individual taxpayer, these advantages and disadvantages will average themselves and year-to-year consistency is the important element. Compare the cash receipt and disbursement method of accounting and reporting income. This method may not be scientific but it is simple and suitable for many taxpayers. Its use will frequently cause income or deductions to be considered in a year other than that in which earned or incurred. This frequently results in an abnormal increase or decrease in tax liability for a particular year. But to the Treasury the average renders these year to year fluctuations in the individual case immaterial.

Now, if this Petitioner did more than make a guess at which method of treating intangible drilling and development costs it should adopt, it necessarily weighed the promised benefits as well as the apparent detriments of the permitted methods. Two advantages were apparent: An immediate reduction in taxable income, and an unlessened allowance for depletion when based upon a percentage of gross income. The disadvantages were the fact that such costs would not be added to cost of property, available for use in computing gain or loss on subsequent sale or abandonment, or cost depletion, and

the probability that on many occasions, there would be no income to absorb the costs which were, nevertheless, to be currently deducted.[84]

In short, Petitioner exposed itself to substantial hazards and detriments in consideration of promised benefits. A substantial portion of these benefits arose out of the established method of computing the depletion limitation. Since at no time after he changed his position (February 15, 1929)[85] did Respondent offer Petitioner the opportunity of changing its 1925 election, he seeks to hold Petitioner firmly to its side of the bargain and at the same time deprive it of this material portion of the consideration therefor.

We submit that there should be most compelling reasons to require the approval by this Court of this obvious inequity.

It has heretofore been argued that Petitioner, and those similarly situated, seek a double deduction,—to deduct intangible costs in computing taxable income and to deduct them again in computing the depletion allowance. This argument is predicated upon an erroneous premise. Those items which enter into the formula by which the depletion allowance and its limitation are calculated are not there-

---

[84]In this very case, in the two preceding years, the results of this Petitioner's operations were such that charging off intangible drilling and development costs benefited it little, if any, as is evidenced by the losses which this record shows it sustained in the two preceding years. (R. 12-13-26).

[85]See in this connection footnote 81, p. 67, supra.

by deducted from or added to income. They are merely elements which, by Statute, are to be used in the formula,—"the rule of thumb," (Helvering v. Mountain Producers Corp, 303 U. S. 376-381; Helvering v. Twin-Bell Syndicate, 293 U. S. 312-321), adopted to simplify the administration of the depletion provisions. "Gross income from the property" is used in the formula, but its use does not duplicate that gross income in computing taxable income. Bad debts are not used in the formula, but the failure to use them does not give a double allowance for them in computing taxable income. There would be no double deduction of intangible costs if the statute had merely directed that the depletion allowance should be 27½ per centum of the gross income from the property. In many cases there is no difference in the depletion allowable regardless of how drilling costs are treated. In no case can the Respondent's assertion as to a double deduction be supported, for it ordinarily makes a difference in allowable depletion of only a small percentage of the intangible costs. The Respondent has not sought to establish, and we do not believe it true, that charging off intangible drilling costs and not taking them into consideration in computing the depletion limitation has from 1925 to date caused this Petitioner to pay less taxes than if it had capitalized such costs. This, alone, would disclose whether this Petitioner obtained benefits, properly or otherwise, from the practice. Respondent should not point alone to the small increase in depletion allowances resulting in this year. It would be a

sorry option, indeed, which did not give some occasional advantage to its user.[86]

CONCLUSION

In 1918, by congressional enactment and departmental regulation, the principles of discovery depletion and optional treatment of intangible drilling and development costs were adopted in computing the tax liability of oil operators. The Treasury has never attempted, by regulation or statutory amendment, to revoke the option granted as to drilling costs. But the Treasury has continuously tried to limit the depletion allowance. At first, and properly, Congress was asked to authorize the limitations sought: those contained in the 1921 and 1924 Laws. But, beginning with the substitution of percentage depletion for discovery depletion no authority for further limitations has been sought from Congress. Instead, a continuing process of imposing further limits by administrative practice and construction was begun. One has but to look at the expanding scope of the Regulations upon the subject to see how this process has operated since 1926. Despite the fact that these changes were never reported to Congress, nor authorization for a change sought there, it has been carried on to the extent that it is now asserted that Congress has approved their conduct.

---

[86]See Commissioner v. Wilshire Oil Company, 95 Fed. (2d) 971, 975, p. 76, supra, to the effect that the Treasury must have expected advantages from the option.

In disregard of express congressional approval of the prior practices, and judicial approval of those practices, this course of gradual encroachment and narrowing down has been studiously continued. To support such a practice is to impinge seriously upon the legislative function, and to give an administrative agency the power to amend a taxing act. The changes which the Respondent now asks this Court to validate go far beyond the permitted scope of departmental regulations. We submit that the Respondent should submit his views to Congress and there seek authority for these changes which actually amend a Congressional enactment.

For all of the foregoing reasons, it is respectfully submitted that the decision of the Court below should be reversed.

HARRY C. WEEKS,
910-13 Sinclair Building,
Fort Worth, Texas.
Counsel for Petitioner.

APPENDIX

Revenue Act of 1932:

SEC. 21. NET INCOME.

"Net income" means the gross income computed under section 22, less the deductions allowed by section 23.

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever.

* * *

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

(a) *Expenses.*—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; traveling expenses (including the entire amount expended for meals and lodging) while away from home in the pur-

suit of a trade or business; and rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

(b) *Interest.*—All interest paid or accrued within the taxable year on indebtedness, except * * *

(c) *Taxes Generally.*—Taxes paid or accrued within the taxable year, except * * *

(d) *Taxes of Shareholder Paid by Corporation.*— * * *

* * *

(e) *Losses by Individuals.*— * * *

* * *

(f) *Losses by Corporations.*—Subject to the limitations provided in subsection (r) of this section, in the case of a corporation, losses sustained during the taxable year and not compensated for by insurance or otherwise.

(g) *Basis for Determining Loss.*— * * *

* * *

(h) *Loss on Wash Sales of Stock or Securities.*— * * *

* * *

(i) *Net Losses.*— * * *

* * *

(j) *Bad Debts.*—Debts ascertained to be

worthless and charged off within the taxable year * * *.

(k) *Depreciation.*—A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence.

* * *

(l) *Depletion.*—In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. * * * (For percentage depletion see section 114(b)(3) and (4).

(m) *Basis for Depreciation and Depletion.*—* * *

* * *

(n) *Charitable and Other Contributions.*—* * *

* * *

(o) *Future Expenses in Case of Casual Sales of Real Property.*— * * *

* * *

(p) *Dividends Received by Corporations.*—* * *

* * *

(q) *Pension Trusts.*— * * *

* * *

(r) *Limitation on Stock Losses.*— * * *

* * *

(s) *Same—Short Sales.*— * * *

* * *

(t) *Definition of Stocks and Bonds.*— * * *

* * *

Revenue Act of 1921:

SEC. 234. (a) That in computing the net income of a corporation subject to the tax imposed by section 230 there shall be allowed as deductions: * * *.

* * *

(9) In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case, based upon cost including cost of development not otherwise deducted; *Provided*, That in the case of such properties acquired prior to March 1, 1913, the fair market value of the property (or the taxpayer's interest therein) on that date shall be taken in lieu of cost up to that date: *Provided further*, That in the case of mines, oil and gas wells, discovered by the taxpayer, on or after March 1, 1913, and not acquired as the result of purchase of a proven tract or lease, where the fair market value of the property is materially disproportionate to the cost, the depletion allowance shall be based upon the fair market value of the property at the date of the discovery, or within thirty days thereafter; *And provided* further, That

such depletion allowance based on discovery value shall not exceed the net income, computed without allowance for depletion, from the property upon which the discovery is made, except where such net income so computed is less than the depletion allowance based on cost or fair market value as of March 1, 1913; such reasonable allowance in all the above cases to be made under rules and regulations to be prescribed by the Commissioner with the approval of the Secretary. In the case of leases the deductions allowed by this paragraph shall be equitably apportioned between the lessor and lessee;

(Note—Sec. 214(a)(10) of the Act contains a corresponding provision with respect to individuals).

Revenue Act of 1924:

SEC. 204 * * * (c) The basis upon which depletion, exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be the same as is provided in subdivision (a) or (b) for the purpose of determining the gain or loss upon the sale or other disposition of such property, except that in the case of mines, oil and gas wells, discovered by the taxpayer after February 28, 1913, and not acquired as the result of purchase of a proven tract or lease, where the fair market value of the property is materially disproportionate to the cost, the basis for depletion shall be the fair market value of the property at the date of discovery or within thirty days thereafter; but such depletion allowance based on discovery value shall

not exceed 50 per centum of the net income (computed without allowance for depletion) from the property upon which the discovery was made, except that in no case shall the depletion allowance be less than it would be if computed without reference to discovery value.

Revenue Act of 1926:

SEC. 204 * * * (c) (2) In the case of oil and gas wells the allowance for depletion shall be 27½ per centum of the gross income from the property during the taxable year. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance be less than it would be if computed without reference to this paragraph.

Regulations 62 (1921 Act):

ART. 201 (h). Depletion allowance in case of discovery: The deduction for depletion in case of a discovery cannot exceed the net income computed without allowance for depletion, from the property upon which the discovery is made, except where and to the extent that such net income so computed is less than the depletion allowance based on cost or fair market value as of March 1, 1913. *Net income is the gross income from the sale of all mineral products and any other income incidental to the operation of the property for the production of the mineral products, less operating expenses, including depreciation on equipment, and taxes, but excluding any allowance for depletion.* If the mineral

products are not sold as raw material but are manufactured or converted into a refined product, then the gross income shall be assumed to be equivalent to the market or field price of the raw material before conversion. Operating expenses, depreciation, and taxes on the property upon which the discovery is made, should be applied against the gross income from the same property on the basis of actual expenditures, but if the records for the year 1921 are in any case inadequate, allocation of such expenditures for that year may be made on the basis of the ratio of (1) the number of wells operated on the property on which the discovery is made to (2) the total number of wells operated in the operating division in which the discovery is included."

ART. 223. Charges to capital and to expense in the case of oil and gas wells.—Such incidental expenses as are paid for wages, fuel, repairs, hauling, etc., in connection with the exploration of the property, drilling of wells, building of pipe lines, and development of the property may at the option of the taxpayer be deducted as a *development expense* or charged to the capital account returnable through depletion. If in exercising this option the taxpayer charges these incidental expenses to capital account, in so far as such expense is represented by physical property it may be taken into account in determining a reasonable allowance for depreciation. The cost of drilling nonproductive wells may at the option of the operator be deducted from gross income as a development expense or charged to

capital account returnable through depletion and depreciation as in the case of productive wells. *An election once made under this option will control the taxpayer's returns for all subsequent years.* Casinghead gas contracts have been construed to be tangible assets and their cost may be added to the capital account returnable through depletion, following the rate set by the oil wells from which the gas is derived, or, if the life of the contract is shorter than the reasonable expectation of the life of the wells furnishing the gas, the capital invested in the contract may be written off through yearly allowances equitably distributed over the life of the contract. All oil produced during the taxable year must be considered in the computation of the depletion allowance for that year. In computing net income all oil in storage at the beginning and at the end of the taxable year must be inventoried in accordance with article 1582. Where deductions for depreciation or depletion have either on the books of the taxpayer or in his returns of net income been included in the past in expense or other accounts, rather than specifically as depreciation or depletion, or where capital expenditures have been charged to expense in lieu of depreciation or depletion, a statement indicating the extent to which this practice has been carried should accompany the return.

Regulations 65 (1924 Act):

ART. 201(h). Depletion allowance in case of discovery: The deduction for depletion in case of a discovery shall not exceed 50% of the net

income, computed without allowance for depletion, from the property upon which the discovery is made, except that in no case shall the depletion allowance be less than it would be if computed without reference to discovery value. *The phrase "net income (computed without allowance for depletion)" means the gross income from the sale of all mineral products and any other income incidental to the operation of the property for the production of the mineral products, less operating expenses, including depreciation on equipment and taxes, but excluding any allowance for depletion.* If the mineral products are not sold as raw material but are manufactured or converted into a refined product, then the gross income shall be assumed to be equivalent to the market or field price of the raw material before conversion. Operating expenses, depreciation, and taxes on the property upon which the discovery is made, should be applied against the gross income from the same property on the basis of actual expenditures.

Regulations 69 (1926 Act):

ART. 221. Depletion in the case of oil and gas wells.—Under section 204(c)(2), in the case of oil and gas wells, a taxpayer may deduct for depletion an amount equal to 27½ per cent of the gross income from the property during the taxable year, but such deduction shall not exceed 50 per cent of the net income of the taxpayer (computed without allowance for depletion) from the property. In no case shall the deduction computed under this paragraph be less than it would be if computed upon the basis of the

cost of the property or its value at the basic date, as the case may be. In general, "the property", as the term is used in section 204(c)(2) and this article, refers to the separate tracts or leases of the taxpayer.

Regulations 74 (1928 Act):

ART. 221 (i). "Depletion allowance based on the income from oil and gas wells": The deduction for depletion based on the income from oil and gas wells shall not exceed 50 per cent of the net income of the taxpayer, computed without allowance for depletion, from the property, except that in no case shall the depletion allowance be less than it would be if computed without reference to the income from the property. The phrase "net income of the taxpayer (computed without allowance for depletion)" means the gross income from the sale of oil and gas less the deductions in respect to the property upon which depletion is claimed, including overhead and operating expenses, development expenses (if the taxpayer has elected to deduct development expenses), depreciation, taxes, losses sustained, etc., but excluding any allowance for depletion. If the oil and gas are not sold on the property but are manufactured or converted into a refined product or are transported from the property prior to sale, then the gross income shall be assumed to be equivalent to the market or field price of the oil and gas before conversion or transportation.

* * *

Regulations 77 (1932 Act):—ART. 221:

(g) "Gross income from the property" as used in section 114 (b) (3) and (4) and articles 221 to 248, inclusive, means the amount for which the taxpayer sells (a) the crude mineral product of the property or (b) the product derived therefrom, not to exceed in the case of (a) the representative market or field price (as of the date of sale) of crude mineral product of like kind and grade before transportation from the immediate vicinity of the mine or well, or in the case of (b) the representative market or field price (as of the date of sale) of a product of the kind and grade from which the product sold was derived, before the application of any processes (to which the crude mineral product may have been subjected after emerging from the mine or well) with the exception of those listed below, and before transportation from the place where the last of the processes listed below was applied. Where there is no such representative market or field price (as of the date of sale), then there shall be used in lieu thereof the representative market or field price of the first marketable product resulting from any process or processes minus the costs (including transportation costs) of the processes not listed below. The processes excepted are as follows:

(1) In the case of coal—cleaning, breaking, sizing, and loading at the mine for shipment;

(2) In the case of sulphur—pumping to

vats, cooling, breaking, and loading at the mine for shipment;

(3) In the case of iron ore and ores which are customarily sold in the form of the crude mineral product—sorting or concentrating to bring to shipping grade and loading at the mine for shipment; and

(4) In the case of lead, zinc, copper, gold, or silver ores and ores which are not customarily sold in the form of the crude mineral product—crushing, concentrating (by gravity or flotation), and other processes to the extent to which they do not beneficiate the product in greater degree (in relation to the crude mineral product on the one hand and the refined product on the other) than crushing and concentrating (by gravity or flotation).

In all cases there shall be excluded in determining the "gross income from the property" an amount equal to any rents or royalties which were paid or incurred by the taxpayer in respect of the property and are not otherwise excluded from the "gross income from the property." Where royalties in the form of bonus payments or advanced royalties (see article 230) have been paid in respect of the property in the taxable year or in prior years, the amount excluded from "gross income from the property" for the taxable year on account of such payments shall be an amount equal to that part of such payments which is allocable to the products sold during the taxable year.

(h) "Net income of the taxpayer (computed without allowance for depletion) from the property," as used in section 114 (b) (2), (3), and (4) and articles 221 to 248, inclusive, means the "gross income from the property" as defined in paragraph (g) less the allowable deductions attributable to the mineral property upon which the depletion is claimed and the allowable deductions attributable to the processes listed in paragraph (g) in so far as they relate to the product of such property, including overhead and operating expenses; development costs properly charged to expense, depreciation, taxes, losses sustained, etc., but excluding any allowance for depletion. Deductions not directly attributable to particular properties or processes shall be fairly allocated. To illustrate; In cases where the taxpayer engages in activities in addition to mineral extraction and to the processes listed in paragraph (g), deductions for depreciation, taxes, general expenses, and overhead, which cannot be directly attributed to any specific activity, shall be fairly apportioned between (1) the mineral extraction and the processes listed in paragraph (g) and (2) the additional activities, taking into account the ratio which the operating expenses directly attributable to the mineral extraction and the processes listed in paragraph (g) bear to the operating expenses directly attributable to the additional activities. Where more than one mineral property is involved, the deductions apportioned to the mineral extraction and the processes listed in paragraph (g) shall, in turn,

be fairly apportioned to the several properties, taking into account their relative production.

G. C. M. 2315,-C. B. VI-2, page 21:

An opinion is requested as to whether development expenditures made in connection with oil or gas wells should be deducted from the gross income of a discovery property in determining the net income from the property within the meaning of section 234 (a) 9 of the Revenue Act of 1921 where the taxpayer corporation, pursuant to article 223 of Regulations 62, elected to deduct such expenditures from its gross income in computing net income subject to Federal income or profits taxes.

Shortly after the enactment of the Revenue Act of 1921, the construction of the proviso inserted in section 234 (a) 9 of the Act that the "depletion allowance based on discovery value shall not exceed the net income, computed without allowance for depletion, from the property upon which the discovery is made" was given consideration by the Bureau, and the decision was reached that the "net income from the property" referred to in the proviso should be computed without regard to development expenditures, that is, that development expenditures should not be treated as a deduction in computing the "net income from the property" regardless of whether the taxpayer corporation under article 223 of Regulations 62 elected to treat such expenditures as operating expenses deductible in computing taxable income or to charge them to capital returnable through depletion.

In view of the decision made at that time, the fact that it has been uniformly followed in closing a great number of cases, and the desirability of a consistent administration of the provision in question, the conclusion is reached that in applying the limitation on discovery depletion in the case of oil and gas wells provided for in section 234 (a) 9 of the Revenue Act of 1921, the gross income from a discovery property should not be reduced by development expenditures in the computation of the "net income from the property," which amount measures the maximum depletion allowance based on discovery which can be allowed in respect to such property. A like construction should be followed in applying the provisions of section 214 (a) 10 of the Revenue Act of 1921 and the provisions of section 204 (c) of the Revenue Act of 1924. The latter section restricts a depletion allowance based on discovery value to "50 per centum of the net income (computed without allowance for depletion) from the property upon which the discovery was made."

The construction herein adopted relative to discovery depletion in the case of oil and gas wells under the 1921 and 1924 Acts should be confined to those Acts. Under section 204 (c) 2 of the Revenue Act of 1926, provision is made that in the case of oil and gas wells the allowance for depletion based upon the gross income from the property "shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property." The term "net income" as used

in that section should be taken to mean the net income defined in sections 212 and 232 of the Act. Accordingly, if a taxpayer elects to treat development expenditures as ordinary and necessary business expenses deductible under section 214 (a) 1 or 234 (a) 1 in computing taxable net income, such expenditures must be deducted in determining the net income from the property, which amount is used as a limitation in the computation of the depletion allowance based on income.

A. W. GREGG,

General Counsel, Bureau of Internal Revenue.

G. C. M. 5104.-C. B. VII-2, page 115:

An opinion is requested as to whether there is a conflict between General Counsel's Memorandum 1023 and General Counsel's Memorandum 2315.

Attention is directed to section 204 (c) 2 of the Revenue Act of 1926, which provides as follows:

> (2) In the case of oil and gas wells the allowance for depletion shall be 27½ per centum of the gross income from the property during the taxable year. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance be less than it would be if computed without reference to this paragraph.

In General Counsel's Memorandum 1023, the question under consideration was whether the income arising from the sale of an interest in oil and gas producing properties could be considered in computing the allowance for depletion under section 204 (c) 2, supra. The conclusion reached in that memorandum was to the effect that the income arising from the sale of oil and gas properties or an interest therein could not be considered in computing allowances for depletion because section 204 (c) 2 had reference to the gross income and the net income *derived on account of oil and gas produced from the property* and not to gross income and or net income arising from the sale of the property or an interest therein.

In General Counsel's Memorandum 2315 the conclusion was reached under the Revenue Act of 1926 that where a taxpayer had elected to treat development expenditures as ordinary and necessary business expenses, such expenditures must be deducted in determining the *net income from the property*, which amount is used as a limitation in the computation of the depletion allowance based on income. In view of the conclusion reached in General Counsel's Memorandum 1023, and in view of the nature of the question under consideration in General Counsel's Memorandum 2315, the statement in the latter memorandum to the effect that the term "net income" as used in section 204 (c) 2, should be taken to mean the net income defined in sections 212 and 232 of the Revenue Act of 1926, must be construed as applying only to the *net income*

derived on account of oil and gas produced from the property.

It is, accordingly, the opinion of this office that there is no conflict between General Counsel's Memorandum 1023 and General Counsel's Memorandum 2315.

C. M. CHAREST,

General Counsel, Bureau of Internal Revenue.

Excerpt from the "Statement of the Changes made in the Revenue Act of 1921 by the Treasury Draft (of the 1924 Act) and the reasons therefor" submitted to Congress during its consideration of the 1924 Act:

"SEC. 204. Paragraph (2) of subdivision (b) supersedes the second and third provisos of sections (s) 214 (a) (10) and 234 (a) (9) of the existing law. The existing law limits discovery depletion to the *operating profit* from the property upon which the discovery is made. The proposed draft limits discovery depletion to 50 per cent of the *operating profit* (from the property) upon which the discovery has been made. Experience in administering the law has shown that the limitation imposed by the existing law is not a sufficient limitation, and it has been considered that 50 percent of the *operating profit* from the property represents a fair limitation upon discovery depletion."

Excerpt from the Report of the Senate Finance Committee, 68th Congress, First Session, explaining changes made in 1924 (Report No. 398, p. 20):

"The exception contained in subdivision (c)

supersedes the second and third provisos of section 214(a)(10) and 234(a)(9) of the existing law. The existing law limits discovery depletion to the *operating profit* from the property upon which the discovery is made. The bill limits discovery depletion to 50 per cent of the *operating profit* from the property upon which the discovery has been made."

Senate Report No. 52, p. 17—Senate Finance Committee, 69th Congress, 1st Session:

> The administration of the discovery provision of existing law in the case of oil and gas wells has been very difficult because of the discovery valuation that had to be made in the case of each discovered well. In the interest of simplicity and certainty in administration your committee recommends that in the case of oil and gas wells the allowance for depletion shall be 25 per cent of the gross income from the property during the taxable year. *The provision of existing law limiting this amount to an amount not in excess of 50 per cent of the net income of the taxpayer from the property is retained.*

House Report No. 356—Conference Report, 69th Congress, 1st Session:

> The Senate amendment makes only one basic change in the discovery depletion provision of existing law so far as such provision relates to mines. It provides that discoveries shall include minerals in commercial quantities contained within a vein or bed discovered in an existing mine or mining tract by the taxpayer after Feb-

ruary 28, 1913, if the vein or bed thus discovered was not merely the extension of a continuing vein or bed already known to exist and if the discovered minerals are of sufficient value and quantity that they could be separately mined and marketed at a profit.

The administration of the discovery provision of existing law in the case of oil and gas wells has been very difficult because of the discovery valuation that had to be made in the case of each discovered well. In the interest of simplicity and certainty in administration the Senate amendment provides that in the case of oil and gas wells the allowance for depletion shall be 30 per cent of the gross income from the property during the taxable year. *The provision of existing law limiting this amount to an amount not in excess of 50 per cent of the net income of the taxpayer from the property is retained.*

The House recedes with an amendment providing that the depletion deduction based upon gross income in the case of an oil and gas well shall be 27½ per cent of that income instead of 30 per cent, * * *.

The above are reproduced from *Seidman's Legislative History of Federal Income Tax Laws*, Page 584.